

Four Dollars

T H E

Spring 1985

BROOKINGS

R E V I E W

Autos

*Robert W. Crandall on Fuel Economy Standards:
Why Not Eliminate Them?*

Defense

Martin Binkin on the Military Pension System

Joshua M. Epstein on Analysis of the Military Balance

Regulation

Robert E. Litan on the Next Four Years

Tax Reform

James D. Robinson III on Charitable Giving

Joseph A. Pechman on Economic Growth

Board of Trustees
 Robert V. Roosa
Chairman
 Andrew Heiskell
Vice Chairman
Chairman, Executive Committee
 Louis W. Cabot
Vice Chairman
 Samuel H. Armacost
 J. David Barnes
 Frank T. Cary
 A. W. Clausen
 William T. Coleman, Jr.
 Lloyd N. Cutler
 Thomas Donahue
 Charles W. Duncan, Jr.
 Walter Y. Elisha
 Robert F. Erburu
 Hanna H. Gray
 Robert D. Haas

Philip M. Hawley
 Amory Houghton, Jr.
 Roy M. Huffington
 B. R. Inman
 James T. Lynn
 Bruce K. MacLaury
 Donald F. McHenry
 Robert S. McNamara
 Mary Patterson McPherson
 Arjay Miller
 Donald S. Perkins
 J. Woodward Redmond
 James D. Robinson III
 Ralph S. Saul
 Henry B. Schacht
 Roger D. Semerad
 Howard R. Swearer
 Morris Tanenbaum
 Phyllis A. Wallace
 James D. Wolfensohn

Ezra K. Zilkha
 Charles J. Zwick
Honorary Trustees
 Vincent M. Barnett, Jr.
 Barton M. Biggs
 Eugene R. Black
 Robert D. Calkins
 Edward W. Carter
 Bruce B. Dayton
 Douglas Dillon
 George M. Elsey
 Huntington Harris
 Roger W. Heyns
 John E. Lockwood
 William McC. Martin, Jr.
 Charles W. Robinson
 H. Chapman Rose
 Robert Brookings Smith
 Sydney Stein, Jr.

THE BROOKINGS INSTITUTION is a private nonprofit organization devoted to research, education, and publication on important issues of domestic and foreign policy. Its principal purpose is to bring knowledge to bear on the current and emerging policy problems facing the American people. Brookings functions as an independent analyst and critic, committed to publishing its research findings for the information of the public. In its educational activities, it works to bridge the gap between scholarship and policy-making, bringing new information and analyses to the attention of decision-makers in the public and private sectors. Its activities are carried out through three research programs (Economic Studies, Governmental Studies, Foreign Policy Studies), an Advanced Study Program, a Social Science Computation Center, and a Publications Program.

The Institution was incorporated in 1927 to merge the Institute for Government Research, founded in 1916 as the first private organization devoted to public policy issues at the national level; the Institute of Economics, established in 1922 to study economic problems; and the Robert Brookings Graduate School of Economics and Government, organized in 1924 as a pioneering experiment in training for public service. The consolidated institution was named in honor of Robert Somers Brookings (1850-1932), a St. Louis businessman whose leadership shaped the earlier organizations.

Brookings receives financial support from philanthropic foundations, corporations, and private individuals; it also draws funding for its activities from endowment income, conference fees, sales of publications, and charges for computer services. In addition, the Institution undertakes some unclassified government contract studies, reserving the right to publish its findings.

A Board of Trustees is responsible for general supervision of the Institution, approval of fields of investigation, and safeguarding of the Institution's independence. The President is the chief administrative officer, responsible for formulating and coordinating policies, recommending projects, and selecting the staff. In recent years the senior fellows and research associates have numbered about fifty men and women with varied backgrounds in the academic world, government, or both.

The officers and staff conduct a continual review of the Institution's fields of interest. Discussions with government officials, members of Congress, business leaders, foundation officers, and other scholars help to identify issues for study. Subjects are selected for study on the basis of their significance and timeliness, the adequacy of information and techniques of investigation, the availability of personnel and funds, and the relationship of the projects to the Institution's objectives. Each Brookings study is offered as a competent scholarly treatment of a subject worthy of public consideration; the Institution itself does not take positions on policy issues.

T H E
BROOKINGS
R E V I E W

Spring 1985, Vol. 3, No. 3

3 Why Should We Regulate Fuel Economy At All?

Robert W. Crandall

8 Military Pensions: The Need for Informed Reform

Martin Binkin

**16 Assessing the Military Balance: Defense Analysis
and the Defense Debate**

Joshua M. Epstein

21 Regulatory Policy in the Second Reagan Term

Robert E. Litan

Tax Reform

**28 Interview: James D. Robinson III on Tax Incentives
for Charitable Giving**

**30 The Treasury Tax Reform Plan: Pro- or Anti-
Growth?**

Joseph A. Pechman

37 At Brookings

The inauguration of the Brookings Center for Public Policy Education.

40 New Publications

Michael Nacht and Bruce G. Blair on nuclear stability. Paul E. Peterson on urban policy. Joseph Grunwald and Kenneth Flamm on offshore assembly. Thomas L. McNaugher on U.S. policy in the Persian Gulf region. Milton D. Morris on the immigration bureaucracy.

Brookings Books

Assessing Tax Reform

Henry J. Aaron and Harvey Galper 1985 / \$8.95 paper; \$22.95 cloth

Who Paid the Taxes, 1966-85?

Joseph A. Pechman 1985 / \$8.95 paper; \$22.95 cloth

Options for Tax Reform

Joseph A. Pechman, editor 1984 / \$9.95 paper

The Age of Vulnerability

Michael Nacht 1985 / \$9.95 paper; \$26.95 cloth

Strategic Command and Control: Redefining the Nuclear Threat

Bruce G. Blair 1985 / \$12.95 paper; \$32.95 cloth

The 1986 Defense Budget

William W. Kaufmann 1985 / \$6.95 paper

America's Volunteer Military: Progress and Prospects

Martin Binkin 1984 / \$6.95 paper

Arms and Oil: U.S. Military Strategy and the Persian Gulf

Thomas L. McNaugher 1985 / \$9.95 paper; \$26.95 cloth

The Global Factory: Foreign Assembly in International Trade

Joseph Grunwald and Kenneth Flamm 1985 / \$10.95 paper; \$29.95 cloth

Immigration — The Beleaguered Bureaucracy

Milton D. Morris 1985 / \$8.95 paper; \$22.95 cloth

The New Urban Reality

Paul E. Peterson, editor 1985 / \$11.95 paper; \$31.95 cloth

The *Brookings Review* is published quarterly by the Brookings Institution, 1775 Massachusetts Avenue, N.W., Washington, D.C. 20036. Second-class postage paid at Washington, D.C. Copyright© 1985 by The Brookings Institution. All rights reserved.

President: Bruce K. MacLaury
Executive Vice President:
Roger D. Semerad
Public Affairs Director:
Margaret M. Rhoades

The Brookings Review
Editor: Mark Goldberg
Secretary: Katharine Beckman

Designed by Meadows & Wiser

Second-class postage paid at Washington, D.C.
USPS I.D. No. 14209; Publication No. 551640; ISSN
0745-1253
Postmaster: Change-of-address cards (Form 3579)
should be sent to:
The Brookings Institution
1775 Massachusetts Avenue, N.W.
Washington, D.C. 20036

No. Copies	Author	Title	Price
			\$

Postage and Handling **2.00**

Total \$

_____ Payment enclosed Bill to my _____ MasterCard _____ VISA

_____ Exp. date _____

Signature _____ Phone # _____

Name _____

Address _____

City _____ State _____ Zip _____

Mail to: Cashier's Office
The Brookings Institution
1775 Massachusetts Avenue, N.W.
Washington, D.C. 20036

XREV33

Why Should We Regulate Fuel Economy at All?

Robert W. Crandall

IN THE 1970s, it seemed only natural for the government to regulate the fuel efficiency of passenger cars. Thus, when the Energy Policy and Conservation Act (EPCA) was passed in 1975, requiring that automobile producers meet increasingly strict "corporate average fuel economy" (CAFE) standards, few demurred. This was a period, after all, in which we were reacting to the shortage of oil by keeping its domestic price artificially low — and by transferring billions of dollars in purchasing power to the Arab states that had created the shortage in the first place. It was common wisdom that the world price of oil would rise in the next several decades — and that, therefore, we could not allow automobile companies to produce cars designed for a regime of artificially low U.S. gasoline prices.

In the 1980s, we have begun to come to our senses. Oil and gasoline prices have been deregulated, and, lo and behold, they have fallen. Surprisingly, the CAFE program remains intact, an anachronism in an age of deregulation. The two largest domestic auto companies would like to see CAFE eased, but no one seems to be pressing for its abolition. Why has the Reagan administration not targeted this program for elimination? How, in 1985, can we justify the continued regulation of passenger-car fuel economy?

CAFE: The Standard Menu

In 1975, Congress decreed that every seller of automobiles in the U.S. market had to achieve, for its fleet of new cars in the 1978 model year, a minimum average fuel economy of 18 miles per gallon (MPG). Thereafter, this standard was to rise in increments, reaching 27.5 MPG by the 1985 model year unless modified by the secretary of transportation. The secretary does have some latitude under the statute to make adjustments, but it appears that she cannot reduce the fuel economy standard below 26 MPG for 1985 or future model years. Domestic automobile companies may not count their captive imports in calculating their compliance with the standard. However, if they exceed the minimum average required for any given model year, they are permitted to carry forward the surplus into subsequent years. Moreover, in some circumstances they may borrow against future surpluses.

Failure to meet CAFE standards can be very expensive. As Table 1 shows, General Motors (GM) and Ford fell short in 1983 and 1984 and are likely to do so once again in 1985. A manufacturer is penalized five dollars per car for each one-tenth of a gallon that its average fuel economy falls below the standard. For example, if, as seems to be the case, GM has no carryforward or carryback credits to use in 1985 and if it averages 25.5 MPG — instead of the 27.5 that the standard requires — across a production of 4 million cars, it could be liable for \$400 million

Robert W. Crandall is a senior fellow in the Economic Studies program at Brookings. He is the author of Controlling Industrial Pollution and co-author of the forthcoming Regulating the Automobile.

Table 1.
*The Big Three's Compliance
with CAFE Standards*

Model Year	CAFE Standard	GM	Ford	Chrysler
1978	18.0	19.0	18.4	18.4
1979	19.0	19.1	19.1	20.4
1980	20.0	21.8	22.0	21.3
1981	22.0	23.2	23.3	26.4
1982	24.0	24.3	24.5	27.0
1983	26.0	23.5	23.8	27.0
1984	27.0	24.8*	25.3*	27.1
1985	27.5	25.1 ^P	25.9 ^P	n.a.

* = mid-year

^P = predicted by the companies

n.a. = not available

Source: NHTSA and *Automotive News*, January 7, 1985, p. 1.

Table 2.
*Automobile Size, Fuel Prices,
and Fuel Efficiency*

Model Year	EPA Estimate of Average Fuel Economy (miles/gallon)	Average Weight of New Passenger Cars (lbs)	Average Engine Displacement (cu. in.)	CPI Motor Fuel (1967 = 100)
1973	14.15	3969	285.5	118.1
1974	14.21	3968	289.3	159.9
1975	15.79	4058	287.9	170.8
1976	17.46	4059	286.3	177.9
1977	18.31	3944	279.0	188.2
1978	19.89	3589	251.6	196.3
1979	20.25	3485	238.1	265.6
1980	23.51	3100	187.4	369.1
1981	25.16	3073	181.4	410.9
1982	26.06	3051	174.2	389.4
1983*	26.01	3115	180.9	376.4
1984*	26.59	3103	179.1	370.7

*Based upon estimated production volumes.

Sources: R.M. Heavenrich *et al.*, "Passenger Fuel Economy . . . Trends thru 1984," U.S. Environmental Protection Agency, SAE Paper #840499, 1984; Bureau of Labor Statistics.

in fines. In order to avoid large penalties, GM and Ford are now pleading for a reduction of the standard to 26.0 MPG. Chrysler, on the other hand, expects to meet the standard and wants it to remain at 27.5 so that virtue will be rewarded. The difference, of course, is that large cars account for a smaller proportion of Chrysler's production than of GM and Ford's.

U.S. manufacturers do derive some benefit from the CAFE program. The fact that importers must meet the MPG standards is an important constraint upon some European firms' participation in the U.S. market. (That same fact reduces the chances that AMC or Chrysler would return to competition with GM and Ford in the large-car market — which may be why GM and Ford have not yet suggested abolition of the entire program.)

"Both the average engine size and the average weight of new cars sold have turned up slightly, as consumers have begun to shift away from smaller cars. Consumers no longer want as much fuel efficiency as their government insists they should have."

Origins

In 1975, when Congress passed EPCA, oil and gasoline prices were being held below equilibrium by regulatory programs devised in response to OPEC's 1973-74 successes. Congress could have and should have encouraged petroleum conservation by allowing prices to rise, but that course of action was discouraged by a political imbalance: Many more buyers of petroleum products than sellers vote in congressional elections.

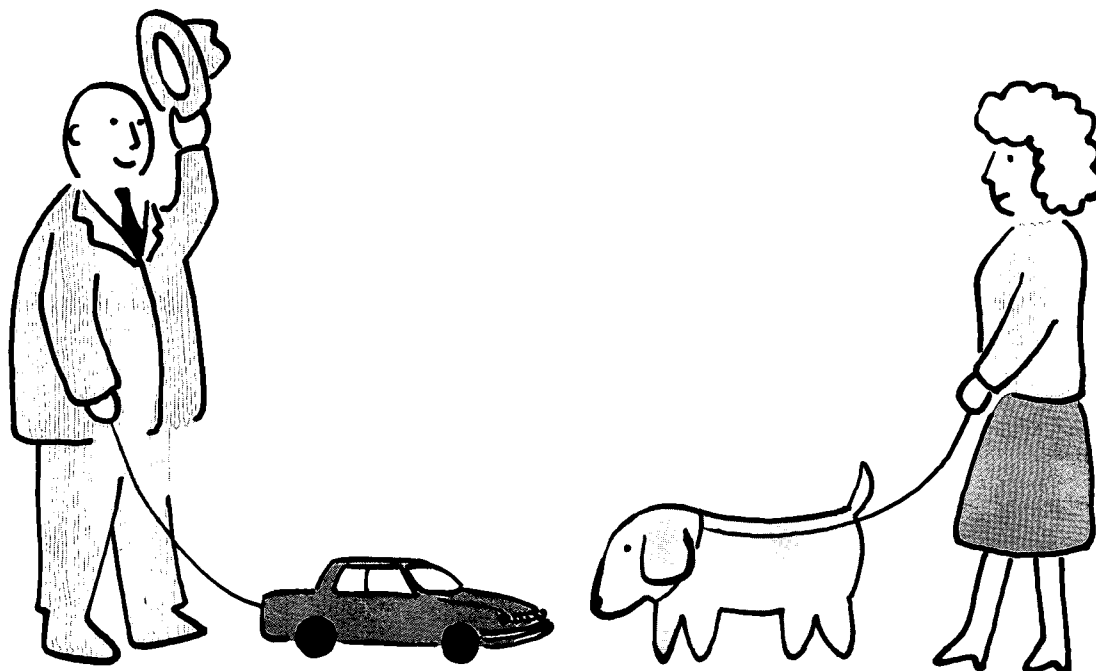
Since Congress had artificially suppressed gasoline prices, so that they did not reflect the scarcity of petroleum, Detroit had no signal to produce appropriately fuel-efficient cars. (Of course, when rationing became severe in 1974 and again in 1979, some consumers might have shown an interest in fuel efficiency—or at least in larger gasoline tanks—in the hopes of avoiding long waits at their local filling stations). Congress decided that Detroit should not continue to produce cars the fuel economy of which was geared to pre-1974 gasoline prices; then, instead of inducing greater fuel efficiency by letting gasoline prices rise, it opted for a direct approach to CAFE standards.

Improvements in Fuel Economy

Even without government requirements, automobile companies were smart enough to provide car buyers with increasing fuel efficiency during a period of rising gasoline prices. The price of gasoline began rising sharply in 1973. Over the next three years, the EPA-rated average fuel efficiency of new passenger cars rose by more than 20 percent (Table 2). Most domestic car companies then began to downsize their fleets, and consumers, knowing a good thing when they saw a small one, shifted their purchasing patterns accordingly. Thus, General Motors, which had started planning its weight-reduction campaign as early as 1971, had by 1976 introduced new downsized standard-size models and the Chevette.

The rate of improvement in fuel efficiency was greater between the 1973 and 1977 model years than between 1978—the model year in which CAFE requirements first applied—and 1984. The second oil shock in 1978-79 led consumers to skew their purchases much more dramatically towards smaller cars. The sales of Japanese imports soared, and the average size of U.S.-produced cars fell. But fuel economy is not just a matter of car size; manufacturers can increase the efficiency of their automobiles, large as well as small, by redesigning transmissions, ignition systems, body shapes, and fuel injection systems. In recent research,¹ I have found that between 1970 and 1983 the rates of improvement in fuel economy for vehicles of any given weight and engine size were almost precisely what would have been expected given the costs of engineering and building in fuel economy and the shifts that took place in gasoline prices. It seems clear that as a factor in inducing fuel-efficient design innovations, CAFE has been largely irrelevant.

Since 1981, the price of motor fuel has fallen by more than 10 percent (Table 2), creating a problem for GM and Ford. Both the average engine size and the average weight of new cars sold have turned up slightly, as consumers have begun to shift away from smaller cars. Consumers no longer want as much fuel efficiency as their government insists they should have.



Robert Wisner

The Case against CAFE

Why should we have supposed that Congress was able to divine well in advance, with only partial information and in a political process, the optimal rate of fuel consumption for passenger cars in any given year? Even if it had done the best job of standard-setting imaginable in those circumstances, the subsequent intrusion of reality — for example, changes in economic conditions and in the technology of automobile production — would have made its handiwork obsolete. And why should Congress have worried only about the consumption of gasoline by automobiles? Surely, it makes no sense to regulate automobile fuel economy and to let energy use in other sectors continue to respond to the distorted prices of crude oil and its refined cousins. Why should the manufacturers of electrical generating equipment, locomotives, or oil furnaces be allowed to design their products to reflect current oil prices? And why is oil different from, say, chromium or copper? Is there not a danger that we may be consuming too much of these precious materials, given their current low prices?

So long as gasoline prices were high and rising, the CAFE standards were without effect. After 1979, no one had to tell automobile companies that they should produce fuel-efficient cars in 1980 and 1981; Japanese imports were giving them this message. And, indeed, in both of those years, the average MPG figures for GM, Ford, and Chrysler were all substantially above the levels mandated by CAFE. But now, with the demand for larger automobiles rising as fast as the dollar, U.S. producers cannot build big cars fast enough — and with the relaxation of the so-called voluntary restrictions on the export of Japanese automobiles to America, they will find it more difficult to sell smaller cars. Ford and GM are succeeding in the market place with their larger cars, but they are failing in the regulatory arena.

If the CAFE standards are continued in this era of declining energy prices, automobile manufacturers will respond in two ways: first, by raising the prices of large cars, and reducing the prices of small cars, in the short run; and,

second, by reducing engine sizes or investing in designs that provide more fuel efficiency than the motoring public desires. The higher prices of large cars will induce some buyers to settle for small ones. But all cars will cost more or have lower performance than they would without CAFE regulation. In short, consumers will lose more than one dollar — through either higher prices or diminished performance — for every dollar's worth of gasoline saved.

Some believe that CAFE will also reduce automobile safety by pushing consumers into smaller cars. This may occur to some extent, but not all of the shift in car buying will be toward smaller cars. Larger automobiles will be outfitted with more fuel-efficient, and less powerful, engines. These cars will deliver less performance on the dollar, but they probably will not be less safe — except on the acceleration ramps of California or Texas freeways.

The CAFE standards, it must be said, are a form of trade protection for U.S. workers. General Motors will be less free to import fuel-efficient small cars from Japan or Korea if CAFE remains, because these imports do not count toward its CAFE rating. If it brings its small cars in from overseas, and produces only large cars in its domestic plants, it will fall far short of CAFE.

This implicit limit on imports will reduce the pressure on the United Autoworkers to agree to the elimination of restrictive work practices and to wage rates that are more in line with the average for U.S. industry. Autoworkers in Japan earn only about 20 percent more than the average for industrial workers there. By contrast, our autoworkers, who are less productive than their Japanese counterparts, earn about 60 percent more than the average U.S. industrial wage. With CAFE in place, U.S. producers will not be able to use as a bargaining chip the threat of foreign supply of small cars.

Chrysler, which currently imports a larger share of its cars from Japan than either Ford or GM does, may benefit if those companies cannot increase their captive imports. But if Ford and GM continue to be constrained by CAFE, they may have to lower the prices of their smaller cars while

raising the prices of their larger ones. This will obviously hurt Chrysler, since it sells mainly smaller cars. Perhaps Chrysler is setting up its rivals for a costly predatory pricing suit.

Other Bases for CAFE?

Are there, lurking beneath the surface of public debate, inarticulated but cogent rationales for CAFE? A brief survey suggests not. One might contend, for example, that oil is different from other natural resources because its consumption is less easily postponed in a national emergency or because it is owned disproportionately by warring Middle Eastern states. But while this line of reasoning might justify the maintenance of larger reserves, it does not provide a plausible basis for artificially rationing the consumption of oil in only one of its many uses.

Alternatively, one might say that oil prices are bound to rise again and that government can protect consumers from making fuelish investments in long-lived, gas-guzzling cars. But that argument cannot be taken seriously, given the government's sorry record of forecasting price shifts. Moreover, if government has a reasonable expectation that oil prices will rise, it can communicate its belief to automobile buyers. Or if it cannot resist activism, it can attempt to impose higher federal taxes on all liquid hydrocarbons. Such a strategy might risk voter disapproval in the next election, of course, but if CAFE is chosen for this reason, then duplicity becomes a guiding principle of government.

Finally, one might argue that CAFE is needed to weaken the OPEC cartel. But if that is our goal, a more powerful mechanism would be a tax on all imports of petroleum or petroleum products. If taxes of this sort were imposed by all petroleum-importing nations, OPEC might collapse. We would then have to weigh the desirability of low oil prices against the costs of instability in the Middle East.

Where Do We Go from Here?

One would hope that we have learned something from our counterproductive interventions in energy markets during the 1970s. We have now deregulated oil and gasoline and are moving towards the deregulation of natural gas. There is serious discussion of deregulating the generation of electric power. In short, we seem to be reaching a societal consensus that markets generally work better without than with government meddling.

At the very least, the supporters of CAFE should be asked to articulate a colorable rationale for continuing this form of social engineering. Gasoline prices are no longer held below market-clearing levels. If we want to reduce gasoline use, let us at least use a gasoline tax that would discourage consumption by owners of older cars as much as by buyers of new ones. If we want to punish OPEC, however belatedly, let us enact an import surcharge on oil and refined products. The path from here seems clear, except for political obstructions: We should let CAFE pass into memory, along with all of those other pleasant events of the 1970s.

1. Robert W. Crandall, Theodore E. Keeler, Howard Gruenspecht, and Lester B. Lave, *Regulating the Automobile*, Brookings Institution, forthcoming.

“Why should we have supposed that Congress was able to divine well in advance, with only partial information and in a political process, the optimal rate of fuel consumption for passenger cars in any given year? Even if it had done the best job of standard-setting imaginable in those circumstances, the subsequent intrusion of reality—for example, changes in economic conditions and in the technology of automobile production—would have made its handiwork obsolete.”

Military Pensions: The Need for Informed Reform

Martin Binkin

BUDGET Director David Stockman recently termed the military retirement plan a “scandal” and an “outrage.” Although this language was generally considered unduly harsh, his comments focused national attention on one of the least glamorous, but most enduring, national security issues. At least once during each administration over the past 16 years, the military pension system has been the subject of official study, its flaws have been identified, and reforms of it have been proposed. But thanks to political impediments and bureaucratic inertia, the system has remained virtually intact.

Calls to change the military retirement plan have typically been motivated by the prospect of savings, and the most recent exhortations are no exception. Indeed, the mounting federal deficit has prompted the gathering of an unlikely coalition of critics. Those who favor more spending on domestic programs deplore the siphoning off of more than \$17 billion this year by military pensions. Proponents of a strong national defense, on the other hand, fear that if the cost of these pensions grows faster than the overall defense budget, the Pentagon will be left with less to spend on current capabilities.

The concentration on cost is understandable, but there is an even more pressing reason to modify the retirement plan: the need to field more effective military forces. By emphasizing youth and vigor in an era when increasingly sophisticated weapon systems put a premium on intelligence and experience, the current retirement program is producing a force profile that is increasingly out of step with the needs of the modern military establishment. Thus, not only does the system exact a large toll from the Treasury, it also generates manpower imbalances that diminish military effectiveness.

The Military Retirement Plan

The U.S. armed forces provide their members with one of the nation’s most generous pension plans. After just 20 years of service, a military retiree is eligible for a lifetime annuity that is protected against inflation and to which the retiree did not contribute explicitly. In addition, he or she is entitled to full social security benefits.

The annuity for retirees is set at 2.5 percent of terminal *basic* pay for each year of service, up to a maximum of 75 percent. (For those who entered the armed forces after September 7, 1980, and eventually retire, the annuity will be based on the average of their highest 36 months of basic pay.) The total value of the annuity thus depends on an individual’s pay grade, years of service, and life expectancy. For example, as Table 1 shows, a typical lieutenant colonel retiring this year after serving 20 years will receive an annual pension of \$20,472. In a funded system, a lump sum of about \$537,000 would have to be on hand at the time of retirement to

Martin Binkin is a senior fellow in the Foreign Policy Studies program at Brookings. His publications include America’s Voluntary Military and Paying the Modern Military. He is a retired Air Force officer.

pay the individual at this rate over his remaining life expectancy. For an annuity of equal value, the retiree would have to have invested over \$13,000 each year during his active career into a fund paying 6.6 percent interest. For a typical master sergeant retiring this year after 20 years and receiving an annual annuity of about \$10,910, the lump-sum equivalent would be \$281,000; to accumulate this amount, an annual investment of close to \$7,000 at 6.6 percent interest would have been required.

Most of those who serve in the military — 88 percent of each entering group — leave before completing 20 years and therefore receive no pension benefits at all.¹ However, for those who do serve long enough to receive benefits, the military plan is substantially more generous than private sector plans and, as Table 2 shows, the system covering federal general schedule employees. It is roughly comparable to the specialized retirement programs for federal protective service officers and air traffic controllers. As the table also indicates, ample military pensions are not unique to the U.S. armed forces. For the most part, though, U.S. military retirees — especially those who serve only 20 years — fare better than their foreign counterparts.

Genesis of the Current Retirement System

The military retirement plan has not always been so generous. Before 1935, military personnel had to serve a minimum of 30 — and, in some cases, 40 — years before they were entitled to retire. In that year, to reduce the unusually large cohort of officers commissioned during World War I, Congress authorized the voluntary retirement of Army officers with as little as 15 years of service. Though it was suspended during World War II, the 1935 legislation remained in effect until 1948.

The statute that superseded it, enacted in 1948, institutionalized the modern nondisability retirement system. In framing the new law, Congress chose to ignore recommendations of the Advisory Commission on Service Pay (called the Hook Commission after its chairman, Charles R. Hook)

that officers be permitted to retire either with 30 years of service or at the age of 60 with 25 years of service and enlisted members with either 25 years of service or at the age of 50 with 20 years of service. While the Army went along with those recommendations, the Air Force and Navy held that “a 30-year retirement system would stifle promotions, preclude the orderly transfer of members to the reserves, and depress recruiting and retention of younger enlisted members.”²

The perceived need for a youthful and vigorous military establishment also undoubtedly influenced Congress. With World War II and the popularized image of the combat infantryman still fresh in the minds of legislators, arguments for maintaining a youthful force were persuasive. Early retirement was considered to be a logical mechanism for controlling the vigor and physical ability of the armed forces.

Relatively low military pay also may have helped to shape the 1948 legislation. Substantial retirement benefits might not have seemed out of line in a compensation system the other elements of which, particularly those paid in cash, were considered inordinately low. Moreover, relatively large retirement annuities were deemed justified as recompense for the special characteristics of military life (the so-called x-factor), which have been described as follows:

“They [military personnel] must be prepared to live anywhere, fight anywhere, and maintain high morale and combat efficiency under frequently adverse and uncomfortable conditions. They are asked to undergo frequent exposure to risk, long hours, periodic relocation, and family separation. They accept abridgement of freedom of speech, political and organizational activity, and control over living and working conditions.”³

The Cost Issue

There is little evidence that the architects of the modern military retirement plan foresaw the magnitude of their legacy. With just 1.4 million under arms, 1948 was a trough

Table 1.
Military Retired Pay, Lump-Sum Equivalent at Retirement, and Annual Deposit Necessary to Accumulate Lump-Sum Equivalent for Nondisability Retirements as of January 1, 1985, Selected Pay Grades

Retired pay grade	Title ^a	Retirement after 20 years		
		Annual retired pay	Lump-sum Equivalent ^b	Annual Deposit ^c
Officers				
0-6	Colonel	22,632	593,351	14,635
0-5	Lieutenant colonel	20,472	536,721	13,238
0-4	Major	17,724	464,676	11,461
Enlisted				
E-9	Sergeant major	12,444	320,843	7,913
E-8	Master sergeant	10,908	281,240	6,937
E-7	Sergeant first class	9,624	248,135	6,120

a. Only Army titles are shown.

b. The lump-sum equivalent is the amount of money required to be on hand at the time of retirement to pay a lifetime annuity to the retiree. Assumes real interest rate of 1.6 percent.

c. Yearly investment, in fund paying 6.6 percent interest, needed to accumulate the lump-sum equivalent.

Source: Department of Defense, FY 1984: DOD Statistical Report on the Military Retirement System, Office of the Actuary, Defense Manpower Data Center, p. 249.

Figure 1.
Trends in Military Retired Population

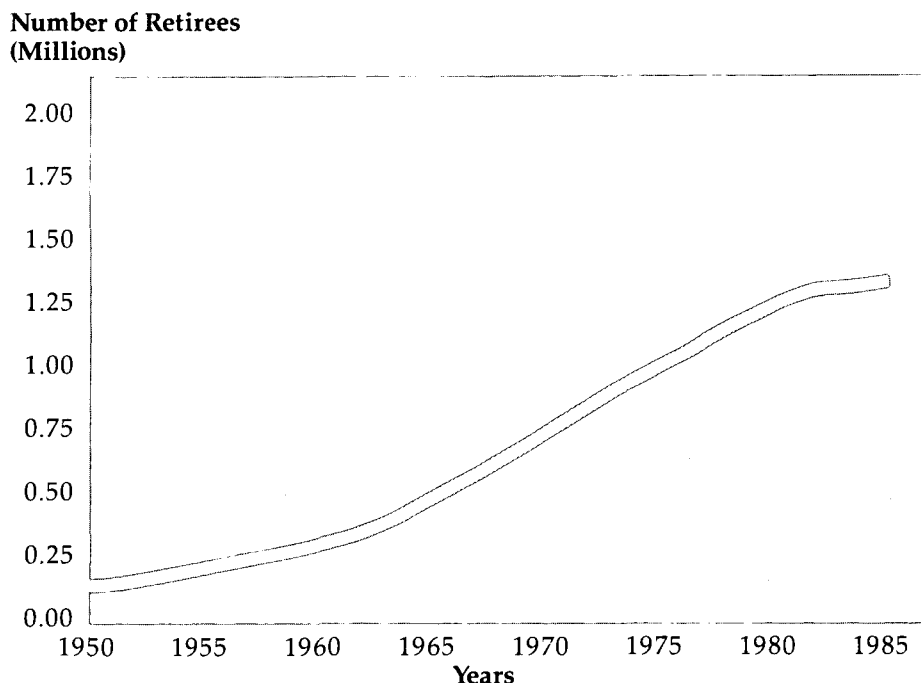
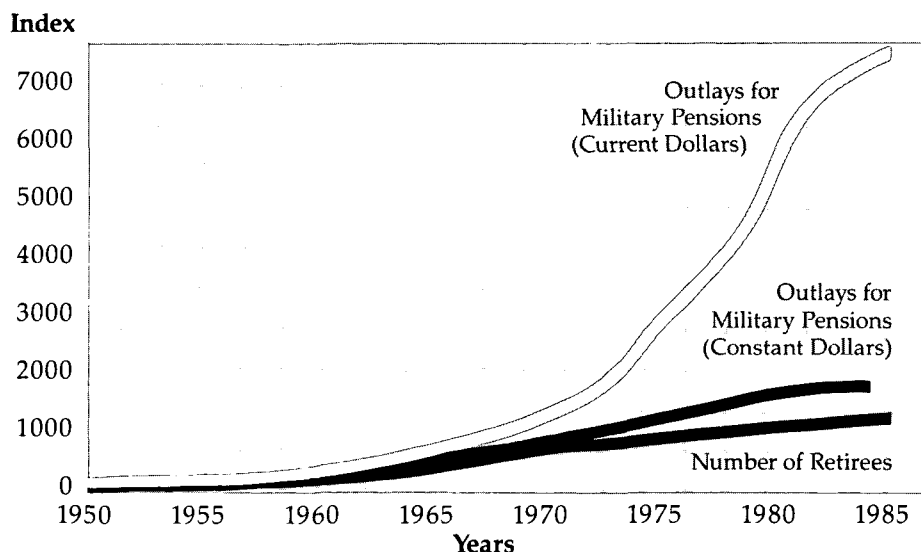


Figure 2.
Outlays for Military Pensions and Trends in Military Retired Population (1950=100)



year for postwar U.S. military strength; only the clairvoyant could have predicted the bulging retirement rolls that were to develop two decades later, largely as a consequence of America fielding the largest standing army in its history. The growth can be traced in Figure 1, which shows that from about 133,000 in 1950, the retired rolls reached 645,000 by 1968, over one million by the mid-1970s, and close to 1.4 million this year. Moreover, the military retired population is projected to continue to grow for the foreseeable future, albeit at a slower rate beyond the year 2000.

Close on the heels of the accelerated growth in the number of retirees in the 1960s were a succession of military pay increases—first, in the late 1960s, to bring military pay up to levels “comparable” with civilian pay, and then, in the early 1970s, to provide the incentives needed to create and sustain a volunteer force. All told, active duty pay rates—the base for calculating initial retirement annuities—grew by over 130 percent in the 1970s alone.

During the same period, cumulative cost-of-living increases in retired pay amounted to roughly 143 percent, outrunning even the relatively high inflation during the decade because, between 1972 and 1976, a quirk in the law permitted retirement pay to grow by one percentage point more than the increase in the Consumer Price Index.

Together these factors have accounted for a dramatic increase in outlays for military pensions, as shown in Table 3; in contrast to the relatively meager \$230 million paid to military retirees in 1950, pension checks this year will exceed \$17 billion. As stunning as that growth appears, much of it can be attributed to the sharp increase in the number of retirees. In fact, per capita disposable personal income, which has increased eightfold since 1950, has outpaced average military retired pay, which has grown sevenfold over the same period.⁴ Moreover, much of the increase in pension payments was the result of inflation. In real terms, the growth in outlays for military pensions is much less spectacular, as can be seen in Figure 2.

Table 2.
Lifetime Retirement Earnings of
Typical U.S. Military Retirees
under Various Retirement Plans^a
 Thousands of 1983 dollars

Retirement Plan	20-Year Retiree		30-Year Retiree	
	Enlisted	Officer	Enlisted	Officer
U.S. Military	329	701	481	973
U.S. Federal Civilian				
General	118	299	234	590
Protective Service	302	688	541	1102
Air Traffic Controller	302	688	434	886
Foreign Military				
Australia	325	645	442	858
Canada	283	560	413	816
Israel	264	560	385	778
Soviet Union	b	b	560	1088
United Kingdom	b	897	280	827

a. Estimates are in undiscounted constant 1983 dollars with no allowance for inflation. It is assumed that all military members retire in 1983 under the October, 1982, pay schedule. Enlisted members with 20 years of service are assumed to retire at age 39 and paygrade E-7, while those with 30 years retire at age 49 and paygrade E-8. Corresponding data for officers are age 43 and paygrade O-5 and age 53 and paygrade O-6, respectively.

b. 20-year retirement not permitted.

Table 3.
Military Retired Pay Outlays
and Average Retired Annuity,
Selected Fiscal Years 1950–85.

Fiscal Year	Retired Pay Outlays (millions of dollars)	Number of Retirees (thousands)	Per Capita Retired Annuity (dollars)
1950	230	133	1,729
1955	422	181	2,331
1960	693	255	2,718
1965	1,386	481	2,881
1970	2,853	765	3,729
1975	6,239	1,044	5,976
1980	11,920	1,265	9,423
1985	17,292	1,377	12,558

Source: Figures for FY 1950–80 from Department of Defense, *FY 1983 DOD Statistical Report on the Military Retirement System*, Office of the Actuary, Defense Manpower Data Center, pp. 6–11. Retired pay outlays for FY 1985 from *Budget of the United States Government, Fiscal Year 1986, Appendix* (GPO, 1985), p. I-H13. Projected number of retirees for FY 1985 from Department of Defense, *Valuation of the Military Retirement System, FY 1983*, Office of the Actuary, Defense Manpower Data Center, p. C–4.

“There is little evidence that the architects of the modern military retirement plan foresaw the magnitude of their legacy.”

"By emphasizing youth and deemphasizing the importance of occupational distinctions, the retirement system has helped to shape a force lacking the experience, especially in technical occupations, to meet the needs of the modern military."

While the cost of military retirement appears less exorbitant when viewed in these terms, there remains reason enough to question the generosity of the plan — and especially whether the principles that underlie it, forged over three decades ago, are still relevant. The contention that a generous retirement plan is needed to complement low active duty compensation has evaporated, as the pay levels of the conscription era have been replaced by wages more competitive with those of civilian workers. The argument that generous pensions are justified by the uniquely arduous nature of military service (the x-factor) has likewise been found wanting. A commission on military compensation set up by President Jimmy Carter concluded in 1978 that the current military retirement system was:

out of balance with most retirement systems and an unfair burden on the American taxpayers. . . . *We find no compelling evidence that the calling to a military career is sufficiently unique to justify the current system.* Likewise, we are not persuaded that the military is so special and different as to invalidate comparisons with other retirement systems. Finally, in view of the many years prior to 1945 when the military functioned without the current system . . . we reject the notion that the current system is a fundamental underpinning of the military way of life.⁵

Similarly, although it recognized that the conditions of military service are in many respects disadvantageous, the Defense Manpower Commission established by Congress and headed by a retired Army vice-chief of staff recommended in 1976 that "there should be no explicit payment . . . made to all or most Service members which is specifically designated as compensation for the x factor." It noted that "in the private sector, there are many occupations or assignments entailing relatively onerous working conditions which employees must be induced to voluntarily accept. . . . Volunteers are attracted by paying differentials only to those individuals who experience the more onerous working conditions and only for the period during which these conditions are experienced."⁶

The Effectiveness Issue

Misguided though it may be, much of the current criticism of the military retirement system understandably has been directed at its generosity and cost, especially in the face of growing federal deficits. But a preoccupation with potential savings has diverted attention from a concern that should be of at least equal importance: military effectiveness. By emphasizing youth and deemphasizing the importance of occupational distinctions, the retirement system has helped to shape a force lacking the experience, especially in technical occupations, to meet the needs of the modern military.

The accent on youth and vigor that underpins 20-year retirement is a vestige of an earlier era when most troops were serving as foot-slogging infantrymen or able-bodied seamen. In today's high-tech military, only 16 percent of all enlisted personnel are assigned to direct combat duties, while close to half serve as technicians or specialists in white-collar occupations. Early retirement may be justified for those who serve long periods in hazardous or physically demanding jobs, but it is less so for those who work in occupations for which youth and vigor are less important than intelligence and experience. The rub is that under the current system, the vast majority of those who leave after only 20 years are serving in noncombat positions when they retire — and a substantial percentage of them *never* served in combat-related jobs.

The often-made contention that the current plan is a vital attraction and retention feature of the compensation system also invites skepticism. There is little evidence that early retirement provisions play a major role in *attracting* new recruits to the armed forces. Obviously, at some point — generally after 10 to 12 years of service — the prospect of retirement benefits becomes an inducement in retaining more senior personnel. But by indiscriminately encouraging service members to seek career status, to serve 20 years, and to retire shortly thereafter, the system perversely in-

asures that the military carries too many of its members to 20 years and too few beyond, all with little regard for occupational qualifications or requirements.

Since retirement holds no value to anyone serving less than 20 years (except in the event of a disability), once individuals have served, say, 10 years, few elect to leave voluntarily and, with the military understandably reluctant to release its unvested members, fewer still are discharged involuntarily. And since those who serve beyond 20 years are working for reduced pay (because they could be collecting a pension while working somewhere else), they are encouraged to retire. Thus, fully 45 percent of nondisabled military personnel who retired in fiscal 1983 had served just the 20-year minimum. The typical enlisted retiree left at age 40, his officer counterpart left at age 43, and both can be expected to collect pensions for over 30 years.⁷

To make matters worse, some of those "pulled" to retirement eligibility are, by virtue of their occupation or performance, unessential to the needs of the armed forces, while some of those "pushed" to early retirement are, by virtue of their skill and the government's investment in their training, important to retain. Offering identical incentives to retain individuals regardless of their skills implies that everyone in a given cohort is making an equal contribution to national defense and that the cost of replacement is the same for each member of that group. In this respect, the retirement system suffers from the same shortcoming as the overall compensation system: By paying their members, across the board and regardless of occupation, on the basis of longevity, the armed forces inadvertently overpay some and shortchange others. As a consequence, they tend to keep the people they can most readily afford to lose and lose the people they most need to keep. The result is a work force badly out of step with the occupational needs of the modern military.

Previous Reform Proposals

These flaws have been widely recognized. Nine studies of the military retirement system — conducted by various commissions, intergovernmental groups, and panels of

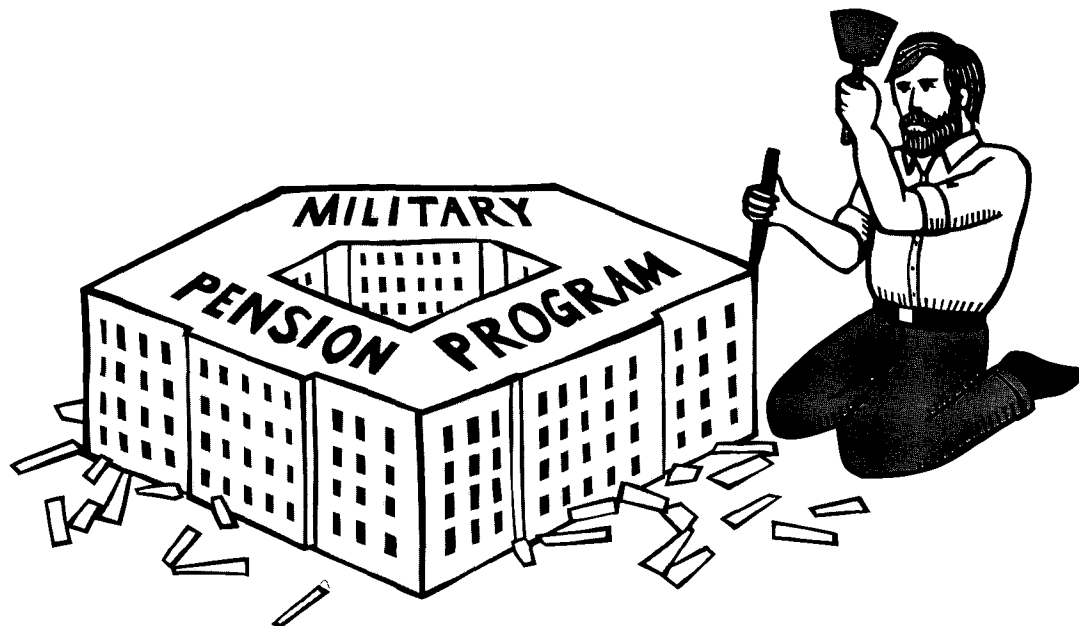
military officers over the past 16 years — have, for the most part, recognized the need to encourage service for some personnel beyond 20 years and to provide some benefits to those who serve less than 20. While the groups took somewhat different views of how to achieve this end, they largely agreed on underlying principles.

Most of the study groups advocated some form of a "two-tier" annuity, which would provide smaller payments during the years when retirees could be expected to supplement their income through civilian employment and larger payments at, say, age 60, when annuitants could be expected to retire completely from the labor force. To encourage service beyond 20 years, all of the study groups recommended a decrease in the multiplier (currently 2.5 percent per year of service) for retirees leaving soon after 20 years are up, an increase in the multiplier for those retiring after well beyond 20 years, or both. Most of the proposals also advocated vesting individuals who serve less than 20 years, in order to improve retention between the fourth and tenth year of service and to increase the military's willingness to release marginal producers prior to the 20-year point. Finally, most of the study groups supported integrating social security with military retirement by reducing retirement annuities by a portion of the social security benefits attributable to military service.

To be sure, some issues have been left hanging: for example, the number of years that an individual should be required to serve to qualify for an annuity, whether early withdrawal of vested benefits should be allowed, and, if so, in what form. These loose ends reflect disagreement on aspects of implementation, but not on the need for change.

Barriers to Reform

How is it, then, that despite all the attention devoted to the military retirement system and the repeated calls for reform, even by groups of military officers, its basic features have remained virtually unchanged for over three decades? Why have only two major pieces of proposed legislation reached Capitol Hill? Why did the Retirement Modernization Act, submitted to Congress in 1973, die in the armed



Robert Wiser

services committees following three years of almost complete neglect, and why was the Uniformed Services Retirement Benefits Act, proposed by the Pentagon in 1979, never even formally introduced in Congress? And, most recently, why did the Reagan administration shelve the report of its own Fifth Quadrennial Review of Military Compensation, which last year recommended revisions to the current retirement plan?

First, and most important, military leaders oppose reform of compensation in general and of retirement in particular. To them, reform means "less." Moreover, Pentagon civilian officials have been hesitant to push the armed forces on this issue, preferring to prod them on issues related to strategy and hardware rather than manpower. Even in the two instances in which legislative proposals were submitted to Congress, lobbying on their behalf by the administration was virtually nonexistent while military officials privately discredited the proposals.

Congress, for its part, has also been unenthusiastic about retirement reform. The complexity of the system makes proposals to change it difficult to understand. In addition, since most past proposals would have grandfathered current retirees and, in some cases, many armed forces personnel still in active duty, immediate savings would not be large; in fact, many of the proposals would have resulted in near-term costs during the transition to a new system. Finally, until recently Congress has been under little pressure to act since the constituency favoring retirement reform has been neither widespread nor well-organized. While the typical taxpayer may have felt that military pensions were overly generous, that feeling apparently did not run deep enough to produce active citizen involvement.

What Next?

Ideally, reform of the military retirement plan should be done in conjunction with an overhaul of the entire military pay system. Pay policy should be designed to vary military compensation in accordance with the nature of an occupation, the job setting, the cost of investment in manpower

training, alternative employment opportunities outside the military, and the potential growth inherent in each occupation. Incorporating such pay distinctions into the structure of military compensation would promote the selective retention of skilled personnel and leave the way clear to design a more equitable and efficient retirement plan, geared principally to provide old-age security.

Practically speaking, however, current circumstances are unfavorable for negotiating such comprehensive reform. A few members of Congress appear ready to entertain fundamental changes, but neither the armed services nor administration officials could be expected to support a recasting of the entire compensation system, given their positions on the narrower question of military retirement.

But the fact that sweeping reforms may have to await the development of more favorable bureaucratic and political conditions should not stand in the way of incremental changes that would improve the system. Indeed, under pressure from the mounting federal deficit, Congress is now considering legislation designed to prompt a modification to the system by limiting the amount the Department of Defense may earmark to fund future retirements.

This tack, which leaves to the Pentagon the task of restructuring the retirement plan to fit within the ceiling, is made possible by a recent accounting change. Starting in fiscal 1985, in place of the amount actually paid to current retirees, the defense budget reflects the accrual cost of retirement — in effect, the amount set aside to fund future retirement benefits being earned by current service.

This seemingly simple accounting change has two important ramifications. First, it forces the Congress to focus on the long-term implications of changes in the military retirement system and, in so doing, minimizes the importance of short-term cost savings. Secondly, it provides the Congress with a convenient metric for assessing the adequacy of the military retirement plan. Instead of getting involved in the details of restructuring the current system, which would undoubtedly entail prolonged committee hearings and floor debate, Congress need only decide on an appropriate ratio of retirement costs to payroll costs. In

"Ideally, reform of the military retirement plan should be done in conjunction with an overhaul of the entire military pay system."

*"Whichever approach it chooses to take, Congress should not be
binded by the allure of cost savings and thus lose sight of the
implications for military effectiveness."*

comparison to the cost of the current military plan, which amounts to 40 percent of payroll (to fund the 12 percent of its members who eventually retire), the cost of the federal civilian plan is about 30 percent of payroll (to fund the 25 percent of its work force that eventually retires). The typical private sector plan, in contrast, is estimated to cost 14 percent of salary.⁸

As of this writing, the House Armed Services Committee had voted to cut \$4 billion from the \$18.2 billion retirement accrual account for fiscal year 1986, effectively reducing the future costs of military retirement to roughly 30 percent of payroll. On the Senate side, a \$1.82 billion reduction proposed by the Armed Services Committee would leave military pension costs at about 36 percent of payroll. The details of the final legislation will depend on floor action in each house and on compromises struck in conference committee.

In any event, care should be taken to ensure that any changes to the retirement plan do not diminish the effectiveness of the force. Since these proposals, if enacted, would reduce the value of future retirement benefits (by 10 percent under the Senate bill and 22 percent under the House version), retention in the 12- to 20-year range could be expected to suffer and the overall experience level of the force to fall.

These effects could be offset by using a portion of the retirement savings to fund additional retention incentives. By one estimate, the experience level of today's forces could be maintained by selectively paying bonuses to personnel in critical occupations at the first- and second-reenlistment points, at a cost amounting to only 10 percent of the retired pay savings.⁹ Better yet, an even larger share of the savings could be plowed back, Congress willing, to increase the experience level of the military work force, by inducing continued service by specialists and technicians in high-skill occupations.

Whichever approach it chooses to take, Congress should not be blinded by the allure of cost savings and thus lose sight of the implications for military effectiveness. The cheapest retirement plan almost certainly will not be the

best retirement plan, but if cost and effectiveness considerations are carefully balanced, the nation could field more effective armed forces and save money as well.

1. The military's 20-year "vesting" rule is in fact much more stringent than what is permitted private employers under the Employee Retirement Income Security Act (ERISA). See Alicia H. Munnell, *The Economics of Private Pensions* (Brookings, 1982), p. 34.

2. *Report of the President's Commission on Military Compensation* (GPO, 1978), p. 52.

3. Testimony of John C. Stetson, Secretary of the Air Force, before the President's Commission on Military Compensation, quoted in *Report of the President's Commission on Military Compensation*, p. 176.

4. Per capita disposable personal income from Council of Economic Advisers, *Economic Report of the President* (GPO, 1985), p. 261.

5. Quoted by General Benjamin O. Davis, Jr., U.S. Air Force (Retired), in *Report of President's Commission on Military Compensation*, p. 179. Emphasis in original. Ten of the 24 members of the commission staff were active-duty military personnel, including the associate director for retirement studies.

6. Defense Manpower Commission, *Defense Manpower: The Keystone of National Security*, Report to the President and the Congress, April, 1976 (GPO, 1976).

7. Department of Defense, "FY 1983 DOD Statistical Report on the Military Retirement System," Office of the Actuary, Defense Manpower Data Center, pp. 131, 146.

8. The accrual cost of military retirement, as indicated previously, is 51 percent of the basic payroll, which constitutes only one portion of the military "salary." When other compensation items (such as quarters and subsistence allowances) are included and account is taken of social security, the accrual cost of military retirement is 40 percent. See CBO, *Modifying Military Retirement*, pp. 25-6. While the Fifth Quadrennial Review agreed with the 40 percent figure for military retirement, it concluded that the private sector figure should be 20 rather than 14 percent, based on its assumptions. Department of Defense, *Fifth Quadrennial Review of Military Compensation*, vol. 1, Uniformed Services Retirement System, January, 1984, p. VII-35.

9. Neil M. Singer, "Retirement Changes and Military Force Planning," paper prepared for U.S. Army Manpower Economics Conference, Williamsburg, Va., December, 1984, tables 8-9.

Assessing the Military Balance: Defense Analysis and the Defense Debate

Joshua M. Epstein

ON ONE issue at least, a bipartisan consensus has surfaced since President Reagan's reelection: The Pentagon must bear its "fair share" of budget cuts in the ongoing effort to reduce the federal deficit. In both houses of Congress, the mechanically neat device of a defense spending freeze has won approval.¹ Secretary of Defense Weinberger protests that defense spending is driven to a unique extent by external — and especially Soviet — factors, and that the national security cannot be held hostage to the deficit. Granted that economic health is itself a component of national security, broadly defined, it is hard to disagree with Secretary Weinberger in principle: The defense budget should be based first and foremost on a rigorous assessment of the East-West military balance.

But is the Reagan administration's appraisal of that balance analytically sound — is it evenhanded and internally consistent? This essay will argue that the answer is "no." After identifying some of the respects in which recent assessments are unsound, it will discuss a way to estimate defense needs more accurately. This technique is called dynamic campaign analysis.

The analytical failings to be reviewed are not unique to the Reagan administration, though they are more pronounced now than ever. It is essential that they be corrected if we are to set national priorities, and make economic choices, in a truly informed and reasoned way.

Unbalanced and Inconsistent Accounting

While the Soviets continue to spend heavily on defense, the rate of increase in their military expenditures was systematically overestimated by U.S. analysts for the period of 1976 to 1981. In the fall of 1983, the CIA officially revised its previous estimate, of between 4 and 5 percent per year, down to 2 percent per year. The rate was lower because, the CIA reported, procurement of military hardware — the largest category of Soviet defense spending — was virtually flat for the entire period. In an update released in February of this year to the Joint Economic Committee, the CIA extended this 2 percent estimate through 1983, noting what it called "a stagnation in spending for military procurement after 1976."²

While the growth in Soviet military spending has been slower than previously estimated, U.S. spending has been greater, and has increased more rapidly, than the administration regularly suggests. Secretary Weinberger continues to refer to the 1970s as a "decade of neglect." In fact, that decade saw cumulative American defense outlays verging on two trillion dollars. From 1976 to 1981 — the much maligned Carter years — outlays grew in real terms at an average annual rate of 2.76 percent, 38 percent higher than the corresponding Soviet figure of 2 percent. In the Reagan years, the average annual growth rate in outlays has jumped to nearly

*Joshua M. Epstein is a research associate in the Foreign Policy Studies program at Brookings. He is the author of *Measuring Military Power: The Soviet Air Threat to Europe and of the forthcoming Strategy and Force Planning: The Case of the Persian Gulf.**

7 percent. Moreover — and this is a truer reflection of relative effort — in *absolute* terms, the NATO alliance as a whole has consistently outspent the Warsaw Pact since 1965.³ Thus, Soviet growth has been overrated while Western efforts have been understated.

This unbalanced accounting has been compounded by inconsistency. Specifically, the CIA's revised figures on Soviet spending have prompted no discernible adjustment in the Reagan administration's portrayal of Soviet might; surely, if the Soviet Union's expenditures are as meaningful an index of its capabilities as the administration has generally suggested, then downward adjustments in U.S. estimates of Soviet spending should produce downward adjustments in our estimates of Soviet strength. Of course, as the CIA itself points out, "trends in Soviet military spending are not a sufficient basis to form judgments about Soviet military capabilities."⁴ But in that case, spending gaps should not be presented as though they translated directly into meaningful military disparities. Relative military strength depends on a host of factors other than expenditure levels.

Unfortunately, the factor that traditionally dominates public debate about the military balance is sheer numbers. Simple numerical comparisons — "bean counts" — can be very misleading. For example, it is often noted that the *number* of Soviet divisions is greater than the *number* of U.S. divisions. But it is seldom noted that Soviet and U.S. divisions are very different. A U.S. active division has almost 60 percent more manpower, is 40 percent more expensive, and, by the Army's own measures, is up to 50 percent more combat-effective than its Soviet counterpart.⁵

The credibility of even the most balanced bean counting is undercut by its inconsistency with the services' own budget requests. To take one of many possible examples, if the Navy truly believes that category-by-category comparison of ship inventories is meaningful, it would have no basis whatever for further procurement of large-deck aircraft carriers (two of which are entering service), since the United States already "leads" the U.S.S.R. in this category, thirteen to zero.

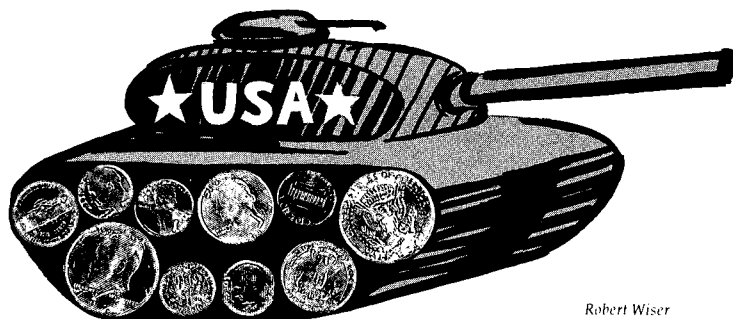
The selective failure to credit quality is a related inconsistency. In general, when the services frame their budgets, they want *quality*, but they tend to assess the Soviet threat as though sheer *quantity* mattered most. If only the numbers matter, then let us not spend so much on quality. And if quality is worth the money we spend on it, then let us not turn around and evaluate the military balance as though numerical ratios alone were reliable predictors of military outcomes; they are not.

Similarly, we spend billions of dollars on battlefield maintenance and support; on logistics and mobility; on training; and on command, control, communications, and intelligence (C³I). If the resulting levels of sustainability, personnel skill, and overall flexibility are worth what we invest in them, then their benefits should be reflected in our assessments of the military balance. All too often, they are ignored.

As a preliminary point, then, it is fair to say that if all relevant parties (i.e., allies) are counted; if apples are compared to apples (rather than oranges); and if the U.S. takes some credit for the operational and qualitative advantages on which we spend so much, the picture — although far from rosy — looks a good deal less bleak than it is generally assumed to be.

Relating Inputs to Outputs

While this overview may offset some of the more pessimistic assessments of the military situation, no such macro-level inquiry can really come to grips with the core question of force planning and budgeting: *What are the requirements of defense in the specific contingencies for which we must plan?*



Robert Wiser

Static comparisons of peacetime inventories of weaponry and manpower, even balanced and consistent comparisons, are patently insufficient to address this basic question. In order to make reasoned, conservative judgments about the adequacy of our forces and about how most efficiently to correct any deficiencies in them, we must relate *inputs* (inventories) to *outputs* (performance in executing missions over time). The superiority of this approach — dynamic campaign analysis — can be illustrated by considering several of the most important campaigns in the conventional sphere, which accounts for the bulk of our spending: the defense of the Persian Gulf, the defense of Europe, and the defense of sea lanes.

Defense of the Persian Gulf

Someone once noted that great harm had been done by politicians using maps drawn on too small a scale. The Persian Gulf is a case in point. The Soviets share a border with Iran, and the *number of Soviet divisions* in the southern U.S.S.R. exceeds — by a factor of over three — the *number of U.S. divisions* comprising the current Rapid Deployment Force. The standard view of the situation can therefore be encapsulated as follows: "They are near; we are far. They are many; we are few. Therefore, conventional defense is close to infeasible." That view, however, is erroneous. For one thing, proximity in and of itself does not ensure access. Between the Soviet Union and the oil fields of the Persian Gulf stand two formidable mountain ranges and an extremely limited, precarious, and vulnerable system of roads and rail lines. What is more, each side's wartime effectiveness (output) would depend on all sorts of operational factors such as warning and the readiness to act upon it, logistics, coordination, reconnaissance, flexibility, combat technology, and troop skill, none of which show up in the raw numerical comparisons that typically pass for analysis.

Using uncomplicated mathematical methods, we can capture these dominant dynamic factors and analyze — in a conservative and plausible way — the relationship between inputs and outputs. Specifically, we can estimate, through careful modeling, how many divisions the Russians could

support in combat in the Persian Gulf; how much delay the United States could impose on a Soviet invasion (by using airpower against transportation “choke points”); and how much force the United States could bring to bear (with airlift and sealift) in the time thus gained. Finally, we can simulate combat between U.S. and Soviet forces.⁶

The word “mathematical” may incline many to dismiss this kind of undertaking as a foredoomed quest for certainties in a world of chance. And, to be sure, anyone hoping for *certainties* in this area would be doomed. But quantification does not purport to attain certitude. Its goal is not to escape the need for judgment; on the contrary, the goal is to confront our judgments and to ensure that they are conservative and that they are arrived at as systematically as our data will permit.

Certainty is a will-o'-the-wisp, judgment an ever-pres-

“Unfortunately, the factor that traditionally dominates public debate about the military balance is sheer numbers. Simple numerical comparisons — ‘bean counts’ — can be very misleading.”

ent hobgoblin, and so one does what common sense would indicate. One makes assumptions explicit; with the available information, one tries to draw inferences that are consistent with those assumptions. The assumptions are then varied so that the *consequences* of irreducible uncertainty may be gauged. In this way, one can identify, for purposes of decision-making, a range of plausible outcomes — and, depending on the degree of uncertainty remaining and the sensitivity of one’s conclusions to it, one buys hedges.

The method is not at all new — and, in fact, it is not inherently “mathematical.” It has claimed various epithets over the years, but they have all been names for the same thing: facing up to the analytical problem and trying to be rational.

What military requirements emerge when the Persian Gulf balance is assessed in this fashion? Reasonable people can disagree about how closely a given analysis approximates the ideal. But this author’s attempt yields a requirement for a force of five divisions, as compared to the seven and one-third division force approved by the Reagan administration. Our highest priority should be to increase the speed of the force, not its size; any U.S. response timely enough to make seven and one-third divisions effective is timely enough to make five divisions sufficient.⁷

Defense of Europe

Similarly, in Europe, while there definitely are improvements to be made, the conventional situation is far from hopeless. Although our allies can and should meet their spending growth commitments, NATO does consistently outspend the Warsaw Pact on defense, and a greater percentage of NATO’s aggregate defense expenditure is directed at the European theatre. (It is often forgotten that upwards of 15 percent of Soviet spending is directed at China.⁸)

The prevailing view of the military balance in Europe is, of course, that the Soviets are unequivocally superior at the conventional level. NATO puts more *in*, but the Warsaw Pact is assumed to get more *out* (in actual military capability). For that to be so, the Pact would have to be more efficient than NATO. There is no convincing evidence of this. Indeed, if the Soviet defense and “civilian” sectors are as diabolically intermingled as is often assumed (in, for example, defense cost estimates that include Soviet railroads), then defense must share at least some of the efficiency problems of its civilian Siamese twin. One may counter that relative efficiency is not decisive since the Soviets face a wartime military task (offense) that is inherently easier than NATO’s (defense). There is, again, very little evidence to support this. Indeed, as good Clausewitzians, the Soviets surely recall the master’s own dictum: “The defensive form of warfare is intrinsically stronger than the offensive.”⁹

One advantage the defender enjoys is the opportunity to fight from prepared — even fortified — positions. By contrast, the attacker must come into the open, exposing himself to fire, in order to advance. Another defensive advantage is the chance to fight on familiar terrain, which in NATO’s case would facilitate the channeling of Soviet armor onto some poor tank country, particularly if the terrain were prepared with field fortifications. Further, in this author’s view, our allies are more reliable than those of the Soviets. Western active units generally receive more train-

ing than Pact units. Moreover, Western training is, in general, substantially more realistic; it draws upon more combat experience and upon the accumulated expertise of militarily skillful friends (e.g., Israel). According to the Joint Chiefs of Staff, NATO enjoys a substantial technological lead in many critical areas.¹⁰

Historically, such qualitative factors have loomed larger than mere numbers. Air-to-air combat is a prime example. In World War II, American pilots in the Pacific theater lost one plane for every 10 Japanese planes they shot down—an exchange ratio of 10 to one. In the Middle East war of 1967 (the Six-Day War), the Israelis scored a ratio of 20 to one; in the Yom Kippur War of 1973, the ratio was 40 to one; in Lebanon, it was over 80 to one. These disparities are explained by technological advantages and, above all, differences in pilot skill. While it would be imprudent to assume Western performance at the higher end of the above range, it is unduly pessimistic to assume no benefit whatever from the West's superior, and more extensive, training and its continuing technological lead.¹¹ As to ground forces, NATO active divisions are, on average, a good deal larger than their Soviet counterparts and are rated by the U.S. Army as more combat-effective—for U.S. armored divisions operating on the defensive, 50 percent more effective.¹²

Obviously, no single measure of relative strength is conclusive, but balanced dynamic analyses taking into account such factors as those discussed above do lend credibility to a statement made by General Frederick Kroesen, commander of U.S. Army forces in Europe: "It disappoints me to hear people talk about the overwhelming Soviet conventional military strength. We can defend the borders of Western Europe with what we have. I've never asked for a larger force."¹³

Defense of the Sea Lanes

The Navy would play a key role in the reinforcement of either the Persian Gulf or NATO. The biggest conventional force efficiencies are to be made in the Navy. Its European mission will illustrate the general point.

For the Western alliance to sustain conventional land and air operations for more than a very few months, the U.S. Navy would have to protect NATO's sea line of communication (SLOC) from Soviet bombers and submarines. But this primary naval objective might be achieved in either of two ways: defensively or offensively. The former tactic would have the Navy deploy its aircraft carrier battle groups south of the so-called GIUK (Greenland-Iceland-U.K.) gaps, there to lie in wait for the Soviets, forcing them to run a series of defensive gauntlets before engaging the carriers and Europe-bound convoys. The alternative would be to assemble a large-scale offensive naval strike force and steam north of the GIUK, north of Norway, and around the Cape to smash the Soviet threat in its lair, Murmansk.

The Reagan administration's support for the latter, offensive, approach is clear. According to Navy Secretary John Lehman, "If we are not able to go on the offense against the Soviet submarine and air threat, if we have to wait for them to come to us, then we can't survive. . . . We have got to go north of the GIUK gap, with sufficient power to defeat the threat. If we have to wait for the submarines to come down through the gap, or even around the Cape, then we're in a losing position."¹⁴ Indeed, Secretary Lehman defended

"In order to make reasoned, conservative judgments about the adequacy of our forces and about how most efficiently to correct any deficiencies in them, we must relate inputs (inventories) to outputs (performance in executing missions over time)."

procurement of two additional large-deck, nuclear-powered aircraft carriers, proclaiming the "capability of a 15-carrier, 600-ship Navy to fight and win in areas of high-end Soviet capability."¹⁵

How, then, would a 15-carrier fleet be likely to fare in offensive operations against the Soviet Northern or Pacific Fleets? Once again, we are dealing with a *specific* campaign, the feasibility of which cannot be gauged by any mere comparison of U.S. and Soviet inventories; as in the cases of the Persian Gulf and NATO, a dynamic analysis, capturing the dominant (and highly asymmetrical) factors, is essential. Such an analysis shows that, in fact, a 15-carrier fleet would stand very little chance of success in conducting offensive operations in these "high threat" areas. Specifically, even on assumptions that are uniformly favorable to the U.S. Navy—"best case" assumptions—a fleet of more than 20 carrier battle groups would be required to execute such op-

erations while also fulfilling assignments in the Mediterranean, the Indian Ocean, and the Atlantic. At an estimated \$18 billion per carrier battle group, that would cost roughly \$90 billion more than the already astronomical price of the 15-carrier, 600-ship Navy.

Fortunately, there is no reason to assume this financial burden. If the Navy secures the sea lanes defensively — exploiting land-based airpower, mining, and anti-submarine warfare in the GIUK gaps — the case for even a 15-carrier fleet fades away; 12 deployable carrier battle groups (13 carriers overall) more than suffice.

The 15-carrier fleet therefore falls between two stools. If the Navy seriously intends to employ aircraft carriers offensively, a 15-carrier fleet is not nearly big enough; we should face the fact that at least five more carrier battle groups, and perhaps \$90 billion more in defense spending, would be required. To safeguard the sea lanes, however, it is absolutely unnecessary to employ carriers in this fashion; defensive carrier employment is equally effective at lower cost (without precluding offensive submarine operations, if they are necessary). If we use the latter, far more efficient approach, a 13-carrier fleet is more than enough.

Balance and Efficiency

This author's analyses show the European and Persian Gulf balances to be more tractable than the administration's statements or budgets would suggest. On the other hand, the prospects for offensive naval operations against Soviet bases emerge as virtually nil.

The immediate budgetary implications of these findings are that the expansion and modernization of America's land and air forces need not proceed at the rates proposed by the administration, and that the surface Navy's offense-driven programs can be curtailed without jeopardizing Western security. While these findings alone provide the basis for considerable savings, the more enduring points are methodological.

First, the defense debate is often inconsistent. To recall just two examples, the Reagan administration (not uniquely) places faith in technological sophistication when procuring weapons, but assesses the Soviet threat as though sheer numbers were the prime determinant of military outcomes; and the administration warns of ominous gaps between Soviet and American defense expenditures, but then leaves threat assessments unadjusted when official U.S. estimates of growth rates in Soviet spending are slashed by a factor of two. Second, and more basic, the debate is dangerously simplistic. Fundamental judgments about the East-West balance of power — judgments that determine the level and distribution of our spending — often rest on little beyond "bean counting." Even when conducted in a balanced and consistent way, the static comparison of financial or material inputs is fundamentally inadequate to the task at hand. Only by the application of dynamic methods — methods that relate inputs to outputs in the specific cases of central military concern — will we elevate the national security debate, bring the real issues into focus, and provide the basis for balanced and efficient defense planning.

1. At the time of this writing, the House had adopted a nominal freeze while the Senate had adopted a real freeze.

2. Robert Gates, deputy director for intelligence, Central Intelligence Agency, "Statement on the Allocation of Resources in the Soviet Union and China — 1984," before the Subcommittee on International Trade, Finance, and Security Economics of the Joint Economic Committee, U.S. Congress, November 21, 1984.

3. The Carter years' growth rate is computed from data given in Congressional Budget Office, *Defense Spending and the Economy*, February, 1983, pp. 2–3. The Reagan rate is computed from data given in the Office of the Assistant Secretary of Defense (Comptroller), *National Defense Budget Estimates for FY 1986*, March, 1985, p. 98. The NATO-Pact data are from Richard D. DeLauer, under secretary of defense for research and engineering, *The FY 1984 Department of Defense Program for Research, Development, and Acquisition*, March 2, 1983, pp. 1–7.

4. *Hearings on the Allocation of Resources in the Soviet Union and China — 1983*, before the Subcommittee on International Trade, Finance, and Security Economics of the Joint Economic Committee, U.S. Congress, September 20, 1983, p. 9.

5. The manpower ratio is from the General Accounting Office, *Defense Spending and Its Relationship to the Federal Budget*, June 9, 1983, p. 15; the cost ratio is from William W. Kaufmann, "Non-nuclear Deterrence," in John D. Steinbruner and Leon V. Sigal, eds., *Alliance Security: NATO and the No-First-Use Question* (Washington, D.C.: The Brookings Institution, 1983), p. 56; the relative effectiveness in armored division equivalents (ADEs) is from William P. Mako, *U.S. Ground Forces and the Defense of Central Europe* (Washington, D.C.: The Brookings Institution, 1983), p. 121.

6. For a thorough elaboration of these methods and a detailed presentation of the calculations, see Joshua M. Epstein, *Strategy and Force Planning: The Case of the Persian Gulf* (The Brookings Institution, forthcoming).

7. Ibid.

8. Barry R. Posen and Stephen W. Van Evera, "Reagan Administration Defense Policy: Departure from Containment," in Kenneth A. Oye, Robert J. Lieber, and Donald Rothchild, eds., *Eagle Defiant: United States Foreign Policy in the 1980s* (Boston: Little, Brown and Company, 1983), p. 73.

9. Carl Von Clausewitz, *On War*. Michael Howard and Peter Paret, eds., (Princeton, N.J.: Princeton University Press, 1976), p. 358.

10. The Organization of the Joint Chiefs of Staff, *United States Military Posture, Fiscal Year 1985*, Chart II–8 (Comparison of Key Military Technologies) and Chart II–9 (Comparison of Technological Levels, Deployed Systems), pp. 16 and 17, respectively. In key military technologies, the JCS rates the U.S. as superior or equal to the U.S.S.R. in 22 of the 23 categories examined. In technological levels for deployed systems, the JCS rates the U.S. as superior or equal to the Soviets in 24 of the 28 categories examined.

11. For these data and a more extended discussion, see Joshua M. Epstein, *Measuring Military Power: The Soviet Air Threat to Europe* (Princeton, New Jersey: Princeton University Press, 1984), pp. 110–112.

12. *Final Report: Weapons Effectiveness Indices/Weighted Unit Values: Vol. I, Executive Summary*, prepared by the War Gaming Directorate, U.S. Army Concepts Analysis Agency (Study Report CAA–ST–73–18), Bethesda, Maryland, April, 1974.

13. General Kroesen is quoted in Senator Carl Levin, *The Other Side of the Story*, May, 1983, p. 1. This assessment, of course, assumes adequate readiness, sufficient strategic mobility, and timely response to warning.

14. "Lehman Seeks Superiority," *International Defense Review*, vol. 15, no. 5, 1982, p. 548.

15. John Lehman, "America's Growing Need for Seaborne Air Bases," *The Wall Street Journal*, March 30, 1982.

Regulatory Policy in the Second Reagan Term

Robert E. Litan

SHORTLY after election to his first term, President Ronald Reagan received a memorandum from Representative Jack Kemp and OMB Director-to-be David Stockman urging that radical economic measures be taken to avoid what they viewed as an impending economic crisis. With the somber title "Avoiding a GOP Economic Dunkirk," the memorandum advised the president-elect to declare an "economic emergency" — and then to propose sizeable budget cuts, seek enactment of the Kemp-Roth tax reduction proposal, and implement a program of "regulatory ventilation" consisting of revisions or rollbacks of existing regulations. The president took this advice — and he was largely successful in following through on each of the components of the Kemp-Stockman economic recovery program.

The regulatory landscape, in particular, has been significantly altered by policies pursued in the first Reagan term. The budgets of most regulatory agencies are down in real terms from their levels of four years ago. The proliferation rate of new rules has slowed, some regulations have been rescinded, and enforcement activities at some agencies appear to have been scaled back.

But perhaps most important, the first-term Reagan team successfully institutionalized for the first time, within the Executive Office of the President, effective oversight of the regulatory actions of all executive branch agencies. Under Executive Order 12291, signed by President Reagan less than a month after he took office, these agencies must clear both their proposed and final regulations with the Office of Management and Budget before publishing them in the *Federal Register*. Until it was disbanded in August, 1983, the Presidential Task Force on Regulatory Relief, chaired by Vice President George Bush, assisted OMB in its review effort.

These procedural changes, however, important though they may have been, were only part of the regulatory agenda that the president's advisers had in mind. The authors of the Dunkirk memorandum, for example, recognized that a number of regulatory statutes — especially those designed to protect health, safety, and the environment — restricted the freedom of regulatory agencies to balance costs and risks against the potential benefits of alternative courses of action. Accordingly, they urged the president to propose within his first 100 days in office a legislative package that would insert provisions requiring cost-benefit, cost-effectiveness, and comparative risk analysis into certain basic enabling acts — including the Clean Air Act, the Safe Drinking Water Act, the Toxic Substance Control Act, and the Occupational Safety and Health Act. The authors warned that "without these statutory changes, administrative rule-making revisions in many cases will be subject to successful court challenge."

Messrs. Stockman and Kemp could not have been more on the mark. As discussed further below, a number of important regulatory rescissions by the Reagan

Robert E. Litan is a senior fellow in the Economic Studies program at Brookings and of counsel to the law firm of Powell, Goldstein, Frazer & Murphy. He is the co-author, with William D. Nordhaus, of *Reforming Federal Regulation*.

"The budgets of most regulatory agencies are down in real terms from their levels of four years ago. The proliferation rate of new rules has slowed, some regulations have been rescinded, and enforcement activities at some agencies appear to have been scaled back."

administration were, in fact, struck down by the courts as inconsistent with underlying statutes or as arbitrary and capricious, and therefore prohibited by the Administrative Procedures Act.

What is more significant, the legislative changes urged by the authors of the Dunkirk memorandum — and later by Murray Weidenbaum, President Reagan's first chairman of the Council of Economic Advisers — were never proposed. In the early months of 1981, inaction on this front appeared to reflect a political decision to give priority to securing tax and spending cuts. Later on, when a window of opportunity for pursuing statutory changes might otherwise have opened up, the administration found itself embroiled in political controversies at EPA and the Department of the Interior that ultimately led to the resignations of Administrator Anne Burford and Secretary James Watt. In such a climate, proposals that could have been construed as weakening environmental protections would have met with an icy reception in Congress.

The Burford and Watt episodes continue to color the politics of regulation (and deregulation), even now that President Reagan has been reelected. There is less support today than four years ago for continued rollbacks of social regulation, particularly of high visibility programs such as those governing the disposal of hazardous wastes. There are even grumblings that the dismantling of controls on prices and entry in the airline, trucking, railroad, and communications industries — begun during the Carter administration and, with some exceptions, carried forward in the initial Reagan term — may have gone too far.

What, then, are the prospects for regulatory policy during President Reagan's second term? Will there be backlash against the administration's first-term efforts to provide regulatory relief? Will these efforts continue, albeit with different foci and techniques? What changes, if any, can be expected in the statutory framework governing the regulatory process? The discussion that follows attempts to answer these questions by projecting likely trends, based on previous actions by the administration, in each of four areas of regulatory policy: regulatory agency budgets, issuance of new rules (including the rescission or modification of existing rules), proposals for legislative change, and regulatory oversight.

Agency Budgets

An important and highly visible component of the Reagan administration's policy toward regulation in its first term was the scaling back of expenditures for many regulatory programs. According to the Center for the Study of American Business at Washington University in St. Louis, the budgets of federal regulatory agencies when the administration assumed office in 1981 amounted to \$6.45 billion, a level 279 percent higher, adjusted for inflation, than the \$1.70 billion (in 1980 dollars) spent in 1970. The Center's figures indicate that over the last four years, however, spending by regulatory agencies declined by 7 percent, to \$6.0 billion (in 1980 dollars) in fiscal year 1985.

The cutbacks in spending have been distributed unevenly. As shown in Table 1, some agencies suffered relatively small reductions in their real budgets between 1981 and 1985 (indeed, the CFTC and SEC enjoyed increases), while other agencies — notably the CAB, ICC, CPSC,

NHTSA, and FTC — incurred substantial cuts.

Some of the budget reductions at economic regulatory agencies were not surprising and probably would have been made if Jimmy Carter had been reelected. For example, pursuant to airline deregulation legislation passed in 1978, the CAB closed shop in December. Similarly, recent legislation loosening the regulation of prices and entry in the trucking and railroad industries has reduced the regulatory responsibilities—and, therefore, the budgetary needs—of the ICC.

On the other hand, the sizeable declines in the budgets of key social regulatory agencies almost certainly would not have occurred in a Carter administration. The reductions at three of these agencies — EPA, OSHA, and NHTSA — are particularly noteworthy, since together the regulations they issue almost certainly have had a greater cumulative economic impact on the private sector than the rules promulgated by all other agencies combined. Nevertheless, it is significant that, with the exception of the budget reduction at the CPSC, the cuts at social regulatory agencies were generally not as severe as those borne by the economic regulators.

Table 1 also indicates that the administration is intent on

making further substantial cuts in the amounts appropriated to regulatory agencies. Its proposed budget for fiscal year 1986 contemplates real reductions in the budgets of all the agencies listed in the table, except the ICC.

Congressional approval of the administration's proposed reductions is far from certain, however — even with all of the attention now being given to narrowing the budget deficit. Total spending at the regulatory agencies currently represents less than 1 percent of the federal budget, and further pruning of their appropriations would have little impact on the overall deficit. Moreover, after the negative political fallout from its first-term regulatory relief efforts, the administration is likely to spend its scarce political capital, during at least the early part of the second term, on expenditure reductions in other areas.

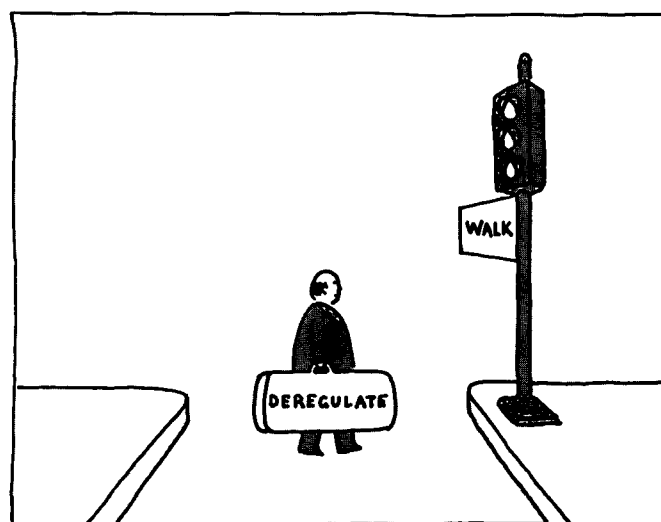
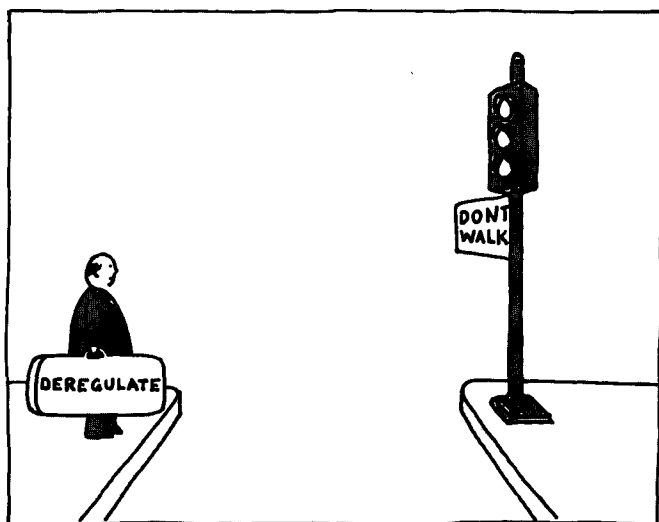
This is especially true given the reluctance by many in Congress to scale back certain regulatory programs. It is quite plausible that some types of economic regulation could be strengthened over the next few years. There is increasing congressional sentiment for reimposing price controls on railroads. The breakup of the "old" AT&T has created a new set of duties for the FCC: regulating, along

Table 1.
Budget Appropriations of Selected Regulatory Agencies
(in millions of dollars)

Agency	FY 1980 Actual	FY 1985 1980 \$s	FY 1986 Proposed in 1980 \$s	% Change (in 1980 \$s) 1980–85	% Change (in 1980 \$s) 1985–86
Economic Regulatory Agencies					
Civil Aeronautics Board	29.5	4.1	—	—86	—
Commodity Futures Trading Commission	16.6	20.9	20.0	+26	— 4
Federal Communications Commission	76.0	71.5	67.8	— 6	— 5
Federal Maritime Commission	11.3	9.4	8.5	—17	—10
Federal Trade Commission	66.1	49.1	46.9	—26	— 4
Interstate Commerce Commission	79.1	36.7	37.7	—54	+ 3
Securities and Exchange Commission	72.7	80.4	79.4	+11	— 1
Social Regulatory Agencies					
Consumer Product Safety Commission	41.3	27.5	24.7	—33	—10
Environmental Protection Agency	524.8	501.3	480.9	— 4	— 4
Equal Employment Opportunity Commission	124.6	122.8	116.6	— 1	— 5
Food and Drug Administration	320.9	313.0	300.5	— 2	— 4
National Highway Traffic Safety Administration	57.4	44.7	40.2	—22	—10
Nuclear Regulatory Commission	400.1	342.4	315.1	—14	— 8
Occupational Safety and Health Administration	186.4	167.8	156.5	—10	— 7

Source: Budget of the United States Government, Fiscal Years 1982 and 1986 (Executive Office of the President, Office of Management and Budget).

Note: Nominal budget figures have been adjusted for inflation by the GNP Implicit Price Deflator, which was assumed to increase at an annual rate of 4 percent in 1985 and 1986. Figures exclude appropriations for grants and supplemental appropriations for civilian pay raises.



with the federal courts, the scope of activities engaged in by both AT&T (the surviving long-distance telephone company) and the regional operating companies. And the recent shock waves in the financial services industry — which have left in their wake record numbers of bank failures — have reawakened interest among many in Congress in tighter bank supervision and regulation.

In the meantime, congressional support for key social regulatory efforts has strengthened in the aftermath of the environmental controversies that punctuated the first Reagan term. After the Burford and Watt resignations, Congress increased the administration's proposed fiscal year 1984 budget for EPA. Congress is mindful of the strong public backing for environmental regulation. A 1983 Louis Harris poll found that public support for stricter air and water pollution laws had risen dramatically since 1981. Over 80 percent of those surveyed said they opposed any weakening of present federal environmental standards.

In sum, aggregate spending on federal regulatory activities is likely to remain more or less stable in real terms over the next several years. Even if the administration really presses for further cuts, the political climate may have shifted enough so that Congress would resist making them.

Issuance of New Rules

Another element of the Reagan administration's first-term regulatory policy was its slowdown in the promulgation of new regulations. OMB figures indicate that through the first 44 months of the Reagan administration, the number of proposed rules issued by federal regulatory agencies fell by 25 percent, and the number of pages printed in the *Federal Register* by 21 percent, relative to the totals from a comparable period in the Carter administration.

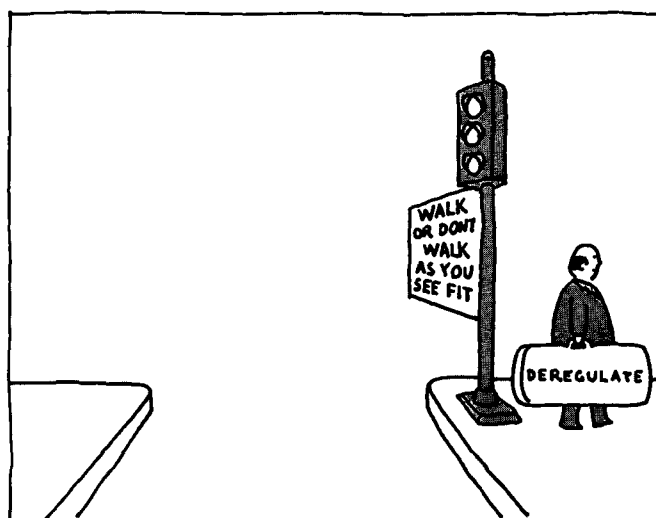
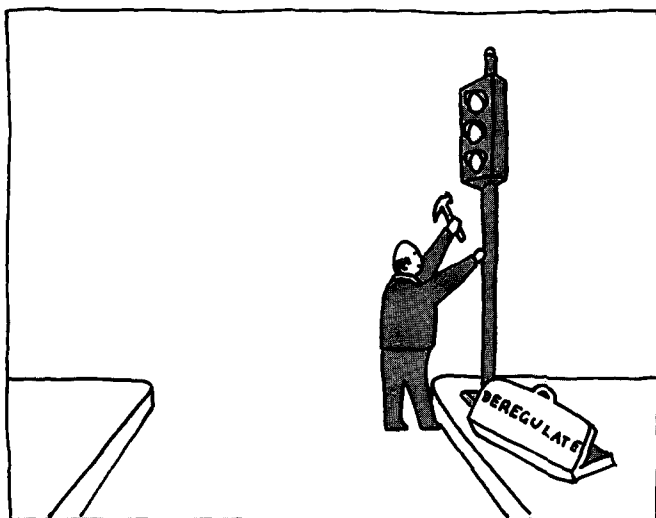
No sharp deviations from this pattern are expected during the second term. To be sure, some regulatory statutes, such as the Clean Air Act, require agencies to issue regulations dealing with specified problems or hazards. However, most simply authorize or direct agencies to develop rules to meet stated regulatory objectives — for example, motor ve-

hicle safety, occupational health and safety, or consumer product safety — without instructing them how many such standards should be set or on what timetable. An administration that is committed to free market solutions — as the present one is — thus has discretion to limit the number of proposed and final rules.

It does not have as much latitude, however, in deciding to rescind existing regulations — a lesson that the Reagan agencies have learned on numerous occasions. Indeed, the administration ran into legal difficulties on its first regulatory rescission: the repeal of NHTSA's passive restraint standard, which was to have required auto manufacturers to begin installing airbags or automatic seatbelts in new automobiles in 1982. That rescission was successfully challenged by the insurance industry. In unanimously affirming an appellate court decision, the Supreme Court held that "an agency changing its course by rescinding a rule is obligated to supply a reasoned analysis for the change" — a test that the Court ruled NHTSA did not meet.

Other agencies also failed this test during the first Reagan term. Among the rescissions overturned by federal district or appellate courts were the repeal by the Bureau of Alcohol, Tobacco and Firearms of the content-labeling rule for alcoholic beverages; the Labor Department's rescission of a regulation that applied minimum wage laws to home knitting; and the loosening by EPA of water pollution standards for the pretreatment of industrial wastes. NHTSA suffered another setback last May, when the U.S. Court of Appeals for the District of Columbia rejected the agency's rescission of tire-grading standards.

In light of these numerous judicial reversals, it is safe to predict that the Reagan agencies will pay greater attention to adhering to the legal requirements of the Administrative Procedures Act, as interpreted by the courts, in regulatory actions taken in the second term. In practice, this will mean more thorough preparation of proposed and final rules and of the analyses that must accompany them. Indeed, good homework by OSHA was instrumental in that agency's successful defense, before the federal appeals court in the District of Columbia, of its rescission of long-standing



Robert Wisner

requirements issued under the Davis-Bacon Act. More recently, the same court, in upholding NHTSA's relaxation of the auto bumper standard, cited in support of its decision the agency's painstaking consideration of all relevant arguments.

Whatever course the administration pursues in the second term, the impact of federal regulation on the private sector will still be substantial. The consensus among analysts who have studied the subject is that prior to 1981 federal regulation imposed on the order of \$100 billion in gross costs — that is, costs unadjusted for benefits — on the private economy each year. Even taking at face value the estimate of the Presidential Task Force that regulatory rescissions through 1983 had saved industry about \$11 billion annually — a figure that many independent observers believe is significantly overstated — the overall private-sector impact of federal regulatory activity remains substantial. This should continue to be true through the next four Reagan years, and beyond.

Proposals for Legislative Change

As already noted, the ambitious plans that some first-term Reagan advisers had for amending or repealing regulatory statutes were largely unrealized. No significant changes were sought in the laws at the top of most regulatory reform agendas: the Clean Air Act; the Occupational Safety and Health Act; and the controversial Delaney clause of the Food and Drug Act, which bans any food additive found to be carcinogenic — regardless of the risk level, the cost of the ban, or any offsetting benefits of the additive. The administration missed its chance to have much influence on the reauthorization of the Resource Conservation and Recovery Act, which together with the Superfund law controls exposure to hazardous wastes. EPA did propose amendments to the Clean Water Act that would have relaxed or delayed the effective date of certain requirements, but its suggestions were received coolly in Congress.

In the realm of economic regulation as well, the administration's first-term efforts to obtain meaningful legislative

change were modest at best. Its only noteworthy success was the passage of the Bus Deregulation Reform Act in 1982, which loosened restrictions on entry into the bus transportation industry. The Department of Energy received high marks for its proposal to accelerate the deregulation of natural gas prices while protecting consumers from excessive price increases. However, the 98th Congress was unable to reach agreement on conflicting natural gas proposals and therefore left untouched provisions of the Natural Gas Policy Act that maintain price controls on gas already discovered ("old gas"), but deregulated prices of newly discovered gas ("new gas") beginning January 1, 1985. In other areas, notably trucking and maritime regulation, the administration offered no proposals for further relaxation of price or entry restrictions. Indeed, the benefits of airline deregulation were slowed by President Reagan's firing of the nation's air traffic controllers in 1981, which led the FAA to impose restrictions on the number of airline flights.

The administration's failure in its first term to obtain meaningful *substantive* reform of key regulatory statutes was matched by Congress' inability to pass *procedural* reform legislation that had been actively supported by both political parties during the Carter administration and the early years of the Reagan presidency. The principal procedural bill in the Senate — S. 1080, sponsored by Senator Laxalt (R-Nev.) — essentially would have enacted into law the regulatory analysis requirement and the OMB oversight functions set out in Executive Order 12291. The Senate passed S. 1080 in both 1982 and 1983. In the House, however, there was far less enthusiasm for new procedural legislation, even if it included provisions designed to curb or eliminate OMB oversight. The House Rules Committee killed H.R. 746, sponsored by Rep. Danielson (D-Calif.), in December, 1982 — and since then there has been no significant House action on procedural reform.

A key factor in the congressional stalemate was the Reagan administration's lack of effort on behalf of either the House or Senate bill. Its disengagement was apparently due to a concern that Congress might end up creating new legis-

“... the most significant change in regulatory policy in the second Reagan administration could prove to be a subtle shift now underway in the nature of OMB’s oversight of executive branch regulatory activity.”

lative obstacles to reforms that the president had already implemented through executive order.

It is unlikely, for the same reasons that so few legislative changes were made in the first Reagan term, that many will be made in the second. Of course, the administration may propose some of its favorite initiatives, such as the insertion of cost-benefit balancing requirements into restrictive regulatory statutes. Nevertheless, after a decade of deregulation, Congress will probably want to pause, so that the regulatory system can digest the changes that have already been implemented. In addition, the moderation of inflation should dampen interest in regulatory rollbacks, particularly since much congressional attention — and much of the Reagan administration’s political capital — is likely to be devoted to reducing the federal budget deficit.

There may be exceptions to this general outlook, however. In the financial services industry, for example, the expanding activities of aggressive institutions like Citibank, Sears, and Merrill Lynch are calling into question the continued viability (or wisdom) of Depression-era restrictions against interstate banking and against bank affiliations with such other financial enterprises as securities firms, investment banking houses, and insurance companies. In its first term, the administration proposed legislation that would have removed the legal barriers between different

financial enterprises provided that each activity is conducted through separate corporate subsidiaries or affiliates. A stripped-down version of this proposal was accepted by the Senate, but later killed in the House. The legislative battle over the powers of financial institutions has already erupted again in this congressional session, along with debate over measures to strengthen federal banking regulation and the deposit insurance mechanisms in the wake of the near failure of Continental Illinois Bank and the recent panic among thrift depositors in Ohio and Maryland.

Environmental policy is likely to be another focus of legislative activity. Two major statutes — the Superfund law and the Clean Water Act — are up for congressional reauthorization (and in its absence would expire on September 30). The chemical disaster in Bhopal, India, has generated interest in the possibility of legislating new safety requirements to govern the transportation and use of hazardous substances. In addition, mounting congressional concern over EPA’s failure to regulate toxic air pollutants may lead to statutory changes that force EPA to act. Lastly, the administration has fought legislation to control acid rain by tightening restrictions on sulfur emissions, but it is possible that some compromise on the issue could be reached by 1986.

Regulatory Oversight

Although it may take time to become recognized as such, the most significant change in regulatory policy in the second Reagan administration could prove to be a subtle shift now underway in the nature of OMB’s oversight of executive branch regulatory activity.

Under the process institutionalized in the first term, OMB’s role was essentially passive. Proposed rules, and the analyses accompanying them, percolated up through the agency bureaucracies and then were reviewed by OMB regulation-watchers. To be sure, OMB did develop a computerized tracking system to provide it with early warning when a proposal was nearly ready for review, and it established a procedure for quick clearance of rules with minor impacts, so that staff members can spend more time considering significant proposals. However, the rules were reviewed one at a time; relatively little attention was paid to the totality of regulatory activity pursued each year and to how — or, indeed, whether — individual rules fit within an ordered framework of regulatory priorities.

By contrast, OMB’s budget examiners work actively with agencies to design individual programs. More importantly, in its annual budget review process, OMB establishes priorities for all federal spending, within and across agencies.

In the second Reagan term, OMB can be expected to try to make its regulatory oversight operations more like its budget review functions. The agency took a major step in this direction in December when it announced a new plan to review the regulatory calendars — that is, the schedules of proposed and final rules — for all executive branch agencies. The president approved OMB’s plan and, on January 4 of this year, institutionalized it in Executive Order 12498.

The following week, OMB issued a memorandum and bulletin requesting that agencies submit by February 21 statements of their regulatory objectives and of the rulemaking initiatives they planned to undertake in the year beginning April 1. OMB indicated it would use these

statements to coordinate regulatory policy across all agencies and to publish each year a compilation of the administration's overall regulatory program.

The new executive order immediately caught the attention of Representative John Dingell, chairman of the House Energy and Commerce Committee, who called for agencies under his committee's jurisdiction to report in detail their relations with OMB. Thereafter, the Environmental Protection Agency and the Department of Transportation — both of them agencies within the committee's purview — held up the submissions of their regulatory statements to OMB.

A strong reaction against OMB's new authority was also registered by Representative Jack Brooks, chairman of the House Government Operations Committee, who announced in April that he would seek to withhold funding for OMB's Office of Information and Regulatory Affairs (OIRA). Brooks' opposition is an important signal of the kind of resistance that the new executive order is developing.

It is interesting to speculate on what Congress might do if it decides to rein in the OMB regulatory shop. One logical step would be legislation establishing procedures for formal congressional review of OMB's expanded regulatory oversight activities. OMB could be required to submit an annual report to Congress in the form of the administration's planned comprehensive regulatory statement, including an agenda of upcoming regulatory initiatives. Congress could require similar reports from each independent agency (such as the FTC, ICC, and SEC). With this information, Congress could assume a major role, together with OMB and the independent agencies, in setting government-wide regulatory priorities.

This author and William Nordhaus have advocated elsewhere precisely this kind of collaborative effort. One shortcoming of the present regulatory system is that once Congress enacts legislation giving agencies the authority to write rules, it does not systematically supervise how that authority is exercised. For example, when Congress passed the Clean Air Act, it effectively wrote blank checks on private-sector bank accounts to achieve a broad, but worthy, social objective: clean air. The "blanks" — that is to say, the costs of achieving, or attempting to achieve, that goal — were filled in as EPA issued regulations and firms made expenditures to comply with them. Although Congress regularly reviews EPA's overall budget and confirms top-level appointments at the agency, it has never attempted to add up the costs and benefits of all the rules issued under the Clean Air Act in order to determine whether in the aggregate they are cost-effective and whether the priorities that they reflect make sense.

Other regulatory statutes are also, in effect, blank checks. This would change, however, if Congress and OMB jointly set regulatory agendas. Both the executive and legislative branches would regularly review not only the overall level of federal regulation, but the numbers going into the "blanks" in the authorizing statutes.

There are small signs that Congress is beginning to recognize the importance of its participation in setting regulatory priorities. For example, in January Representative Joe Moakley, a senior Democrat on the House Rules Committee, introduced legislation to establish a Joint Committee on Regulatory Affairs to review all federal regulations. Under Moakley's proposal, Congress could block the imple-

mentation of a rule it did not like by temporarily freezing appropriations. During the freeze period, the Joint Committee and the appropriate standing committees in each house could work together on more durable measures.

The nation is still a long way, however, from systematic congressional oversight of the executive branch's regulatory decisions. There is no consensus on whether and how Congress should go about such oversight activities. This has been evident since the Supreme Court ruled in 1983 that the legislative veto — which Congress had resorted to more and more frequently in order to cancel agency actions it did not approve of — was unconstitutional. Although a variety of possible replacements for the veto have been proposed, Congress has yet to settle on a new strategy.

Now that OMB is moving aggressively to solidify and extend its oversight capabilities, Congress may finally be impelled to do something on its own. For those interested in regulatory reform, the most interesting question regarding the next four years is not what will happen to regulatory agency budgets, particular rulemaking proposals, or recommendations for statutory change; it is how regulatory oversight will be carried out in the second Reagan term and what response it will elicit from Congress.

"One shortcoming of the present regulatory system is that once Congress enacts legislation giving agencies the authority to write rules, it does not systematically supervise how that authority is exercised."

James D. Robinson III on Tax Incentives for Charitable Giving

James D. Robinson III is chairman of the board of American Express Company, chairman-elect of United Way of America, and a trustee of the Brookings Institution. In April, he spoke with Mark Goldberg of the Review about the relationship between the tax law and charitable contributions. His comments about the Treasury tax reform package apply with equal force to the administration's revised proposal, which, like its predecessor, would eliminate the charitable deduction for non-itemizing taxpayers and limit deductions for gifts of appreciated property to the smaller of the fair market value of the asset or its purchase price adjusted for inflation.

Q Assuming that we are not on the verge of moving to a vastly simplified tax structure—that is, assuming that we are going to continue to have a tax law that creates incentives for some activities and disincentives for others—what basic principles should guide the tax code's treatment of charitable contributions?

I would rank charitable contributions among the highest priorities—not exactly equal to the defense budget on the spending side, because obviously we have got to have a strong defense, but on that order of significance. The reason is that charitable contributions support so much at the community level—the meeting of human service needs, cultural activities, and so on. The \$60 billion or so raised annually is an important part of American life, and it represents a more efficient way of addressing many problems than imposing a federal tax to raise money, deducting administrative costs, and sending the money back out.

So I would propose two guidelines. First, incentives for charitable giving have been part of the tax code since 1917—they're embedded in the fiber of the country at this point—so as we move ahead on tax reform, they should be tinkered with last or least.

Second, these incentives should be available to all of the people, rather than just to some, so that you encourage the broadest possible participation in charitable giving. The affluent do account for a disproportionate share of giving, and it can be argued that tax incentives are less significant at lower income levels. But in the interest of fairness and in order to include as many people as we can, we should be willing to accept some inefficiencies in the lower brackets as a tradeoff for volunteerism.

On the average, for every dollar that the federal government foregoes in tax revenues as a result of the incentives for charitable giving, the non-profit sector receives about \$1.20 in contributions.

Q Apart from that efficiency, you see special value in having non-profit organizations taking on problems at the community level?

Absolutely. I think that more and more people realize that the federal government can't do everything—that it can't afford to do everything and that it can't deliver care. There are some programs—caring for the homeless, caring for the poor, assisting battered mothers, and so forth—that are local issues; we ought to provide incentives to generate money and involvement to deal with these issues. Needs will vary from community to community, so that services can most effectively and efficiently be provided at the local level.

Q How do the budget cuts being made at the federal level affect the need for the provision of services by non-profit organizations?

The programs that would be cut most under current budget proposals are the domestic discretionary programs. Many of these are aimed at human needs at the state and local levels, as were the programs most heavily impacted by the 1981 budget cycle.

To phase out or terminate or substantially reduce these programs at a time when you are also taking away the incentives for charitable giving is a double whammy—and in my view, it's crazy public policy. It goes very much counter to what the president is trying to encourage: volunteerism, so that citizens at the grassroots level deal with their own grassroots problems, rather than looking to the federal government.

Q Non-profit organizations have been expressing alarm about the provisions of the Treasury tax reform package that would modify the tax code's treatment of charitable contributions. But several studies have suggested that the lowering of marginal rates called for by Treasury would have just as deleterious an effect on the volume of charitable contributions as those provisions. Is that your sense of it—and, if so, what would be the appropriate response?

If you have lower tax rates, then by definition the cost of

giving goes up. The projections I have seen indicate that the Treasury proposal, taken as a whole, would cut charitable contributions by between 17 and 24 percent — or roughly \$12 to \$15 billion a year. According to the estimates, lower rates would lead to a reduction of about 8 to 10 percent, and the balance would come from changes in the particulars of the present tax law.

So something on the order of less than half of the impact would come from lower rates. Now whether that would be made up in part because people would have more discretionary income and therefore would give a little bit more — who knows at this date?

What this says to me is that because charitable giving is a very efficient way to deal with community needs, the Treasury and Independent Sector and anyone else who wants to take the time to look at these issues ought to be thinking about ways to provide even greater incentives.

15 Something to offset the impact of the lower rates?

Not only to offset it. If I had a distribution system that was more efficient than the one I have been using, I would be figuring out how to use it more.

16 One of the ideas that has been suggested is having a tax credit instead of a deduction. Is that something you would be interested in?

I would think that any of these kinds of ideas — tax credits, matching programs of one form or another — ought to receive serious and rigorous study.

17 Treasury is arguing that the charitable contributions provisions of the current tax law are, like many other provisions, tax preferences that have to be trimmed back so that we can lower rates. Do you buy that argument?

Not at all. I don't see the deduction for charitable giving as a tax preference. I see it as a fundamental incentive that we have had in this country since the early 1900s. Individuals don't benefit directly from this like they do from tax shelters; the society around them benefits. Of course, there may be some excesses, such as giving away property based on inappropriate valuations or something like that. But that is a policing problem, not a loophole issue.

18 Let's turn to the parts of the Treasury proposal that are aimed specifically at contributions. The first is the elimination of deductibility for non-itemizers. One of the arguments that Treasury makes is the verification argument you just referred to. How worried should we be about that, and, if we are worried, is there a way to beef up the verification without eliminating the deductibility?

Well, I haven't spent time figuring out how to beef up the verification, but if I were really worried about it I might try to find a way to put penalties on clearly erroneous appraisals, so that the cost of being caught wrong would be very substantial and the risk-reward ratio would be different than it is now. I would say to the accounting profession that it is time for them to figure out a way to simplify the verification process — that they should dedicate some pro bono time to coming up with ways to improve the system.

So I think that the verification issue is a relative red herring — and certainly as to non-itemized deductions, which are important to United Way, it is a red herring.

19 As the law now stands, the provisions regarding deductibility for non-itemizers are being phased in over a five-year period. In 1985, the ceiling on the amount of giving that can be claimed — this past year, it was \$300 — will



be eliminated, and 50 percent — instead of the current 25 percent — of the total will be deductible. It is clear that you favor some deductibility for non-itemizers. Is there a point along that continuum that strikes you as better than the other points?

In other words, could you stop at 50 percent or do you have to go to 100 percent? That's a legitimate question. The effort should be to make the deduction for non-itemizers equivalent to what itemizers enjoy.

20 The reason I am especially interested in this is that, as you know, if nothing is done — that is, if the Treasury proposal is not adopted and the law remains as it is — the deductibility for non-itemizers will expire after 1986. So for deductibility to continue in some form, something affirmative will have to happen.

That's right, and that is why one of United Way's prime objectives — until it was distracted by the Treasury plan — was to make the deduction for non-itemizers permanent.

21 Treasury contends that those who give appreciated property are getting away with something because they are not paying taxes on appreciation, and that as a result we have an artificial incentive for people to give appreciated property instead of cash. Do these arguments have merit?

They have merit, but my response is thank God. You get a much bigger multiple at that level of giving, so that the fact that you can avoid paying capital gains tax by giving appreciated property without a doubt brings the institution that receives it more money than it would otherwise get. That is a perfect example of a positive yield impact from the tax law.

22 If the administration backs off of the provisions in the Treasury proposal that relate specifically to charitable contributions, what ought to be the agenda of the non-profit sector in this area over the next couple of years?

The emphasis will be on making permanent the deduction for non-itemizers. And we need to go beyond the numbers game. We need to develop more fully the rationale for voluntarism in this country and the incentives for involvement, because these are powerful forces that already work far better here than any other place I'm aware of — and we can do substantially more in the future.

The Treasury Tax Reform Plan: Pro- or Anti-Growth?

Joseph A. Pechman

THE TREASURY Department's tax reform plan, released in November, 1984, proposes far-reaching changes in the taxation of business and investment income. The most important of these are substitution of real economic depreciation for the accelerated cost recovery system (ACRS) and the investment tax credit, repeal of preferential provisions for financial institutions and the energy and mining industries, a new deduction for half of the dividends paid by corporations, adjustment of interest income and capital gains for inflation, and reduction of individual and corporation income tax rates. The purpose of these changes would be to restore the neutrality of the tax system as it applies to different assets and industries and improve the allocation of capital in the economy.

Since its announcement, the Treasury plan has been attacked by some who argue that it would reduce investment and impair economic growth and praised by others who believe that tax neutrality would increase efficiency and raise the production potential of the economy. Both the criticism and support reflect to a considerable extent the interests of particular groups in the economy that are likely to lose or gain if the plan is adopted. But there are also legitimate questions involved in the debate over the plan—questions that divide even the experts who have studied tax policy issues intensively over the years.

On January 28, 1985, the Center for Public Policy Education and the Economic Studies program of the Brookings Institution convened a research conference to consider why analyses of the Treasury plan differ so much. The conference, which was attended by 40 prominent economists, examined the effects of the Treasury plan on the cost of capital, business investment, residential and commercial construction, interest rates, and international capital flows. This article summarizes the conclusions reached at the colloquium and the issues that remain for further research.

The Cost of Capital

Economists have developed the concept of the cost of capital to analyze the effects of taxation on investment incentives. The cost of capital is the rate of return before tax that a particular investment must yield in order to pay taxes, recoup real depreciation, and cover the after-tax cost of funds to the firm. If the cost of capital increases, business investment is discouraged; if it declines, investment is encouraged. The cost of capital can be estimated for particular assets and industries as well as for the business sector as a whole. Clearly, increases or reductions in taxes—through changes in capital consumption allowances, special preferences, or shifts in tax rates—can have significant effects on the cost of capital and hence investment decisions.

Joseph A. Pechman is a senior fellow in the Economic Studies program at Brookings. His books include Who Paid the Taxes, 1966-1985?, Options for Tax Reform, and Federal Tax Policy.

Two sets of estimates of the Treasury plan's impact on the cost of capital were presented at the conference, one by Jane G. Gravelle of the Congressional Research Service and the other by Charles R. Hulten of the Urban Institute. Their calculations suggest that the overall effects of the Treasury's corporate tax proposals would probably be small, but that the effects on a number of individual industries could be significant.

Gravelle and Hulten agree that the Treasury package would reduce the cost of capital for equity-financed structures and increase it for equipment. It stands to reason that elimination of the investment tax credit now given for equipment purchases and reduction of the corporate tax rates would favor structures — and cost of capital calculations confirm that this would be the case. The largest increases in the cost of capital would occur in transportation, communications, and public utilities, which receive large investment tax credits, and the smallest would take place in the trade and services industries.

Hulten pointed out that while total corporate tax liabilities would increase under the Treasury plan, changes in the cost of capital would be small because the basic corporate tax provisions of the package (repeal of the investment tax credit, revision of the depreciation allowances, and the new dividend deduction) would be roughly offset by the cost of the reduction in corporate tax rates. Increases in corporate taxes would be concentrated in three sectors — energy, financial services, and activities that involve multi-period construction — that would lose the tax advantages they now receive.

Participants in the conference generally regarded the estimates prepared by Gravelle and Hulten as being "in the ballpark." However, for a number of methodological reasons, they urged that the estimates be used with caution. It was emphasized that such projections should take into account proposed tax changes that would affect individuals as well as those aimed at the corporate sector. The estimates presented at the conference did not reflect, for example, the lowering of individual income tax rates, which would reduce the tax wedge between the earnings of firms and the after-tax returns of savers. Perhaps more important, the calculations did not allow for the effects that the indexation of interest income and expenses would have on interest rates (see the discussion below). Nor were they adjusted for the fact that a significant proportion of the capital available to business comes from tax-exempt or nearly tax-exempt sources, such as pension funds, IRAs, and life insurance companies. Corporate financial policy is another significant variable to be factored in, particularly since a considerable percentage of total investment is financed by debt. In addition, there are provisions in the tax code other than depreciation allowances and the investment tax credit that affect investment. These include the sections governing capital gains, expensing of research and development costs, and the treatment of business property bought and sold many times. Finally, the intangible parts of the nation's capital stock are subject to highly variable tax rates — ranging from research and development, which is expensed and is eligible for a tax credit, to the development of know-how, which may be subject to full tax rates without depreciation. It is clear that the assumptions used in cost of capital calculations must be examined critically before those calculations are relied on for policy purposes.

Investment

The effect on investment of a major change in taxation cannot be estimated by cost of capital calculations alone. The full ramifications of such change can be captured only by following through the reactions to it in the various sectors of the economy. Such an analysis requires the use of a well-developed model. At the Brookings conference, calculations derived from two of the country's best known models — those developed by Data Resources, Inc. (DRI) and Wharton Econometric Forecasting Associates, Inc. — were presented.

According to Nigel Gault, DRI forecasts that investment in both business equipment and structures would decline in the first three years of operation under the Treasury plan — and then return to the baseline in the following five years. While the personal tax cut and increased dividends would boost consumer expenditures, DRI estimates that reduced corporate cash flow, due to a shift in the tax burden, and an initial increase in the cost of capital for equipment would depress corporate investment. The reduced value of deductions for secondary residences would lower home prices and therefore cut the amount of new residential construction. The size of the labor force and the number of hours worked would increase as a result of the reduction in tax rates, driving down wages and increasing employment. GNP would be slightly lower in the first four years, but it would exceed the baseline after that.

In the Wharton model, which was explained by Nariman Behvaresh, investment is driven by general economic conditions (through the accelerator effect) and by the cost of capital. The impact of the Treasury plan on investment was calculated, industry by industry, on the basis of the estimated effective tax rates in each. According to the Wharton projections, in the first year following adoption of the Treasury recommendations, consumer expenditures would increase — because of tax cuts — and investment would rise modestly. Then, as the effect of increases in the cost of capital became more pronounced, investment would decline slightly and remain below the baseline for the following eight years. Real gross national product would be about one-half of one percentage point lower in the first two years under the Treasury plan, but would recover to within one- or two-tenths of a percentage point in later years.

Dale Jorgenson of Harvard University presented an entirely different kind of model to estimate the effects of the Treasury plan — one that emphasizes the long run, over which the capital stock adjusts fully to changes in the after-tax rate of return, rather than the short run, in which the capital stock adjusts only partially. According to Jorgenson, the tax neutralization effected by the Treasury proposal would generate large efficiency gains, raising GNP by about 3 percent and national wealth by 8 percent. DRI made similar calculations, but concluded that efficiency gains would amount to less than 1 percent of GNP.

The conference participants raised a number of issues regarding the DRI and Wharton models and results. Tax reform of the type proposed by the Treasury is concerned with the efficiency of resource use, rather than with short-run macroeconomic developments. Both models assumed that monetary policy would remain unchanged (i.e., that the rate of growth in the money supply would not be altered). If output were to decline in the short run, as both

models suggest, it could be offset by a modification of monetary policy. The right question to be asking about the Treasury package is whether it would increase economic efficiency and by how much. Although the participants did not necessarily agree with the figures that Jorgenson obtained from his model, they felt that his attempt to measure long-run efficiency gains was a more suitable approach for evaluating the enduring effects of the Treasury plan.

It was observed that much of the difference between the DRI and Wharton outcomes was due to the use in DRI's model of aggregate corporate cash flow. As already noted, the increase in corporate tax liabilities under the Treasury plan would be attributable mainly to the proposed changes in the preferential treatment of specific industries; the basic changes called for in the treatment of all capital would be roughly offsetting. Thus, the cash flow effect for most industries should be relatively small. Moreover, the switch to a less accelerated depreciation scheme — one that would increase tax payments in the early years of asset lives — would generate a transitional reduction in cash flow that would later be reversed when tax payments declined.

A serious problem with the use of the current macroeconomic models to predict the economic effects of the Treasury plan is that they provide very little basis for estimating the combined impact of tax changes at the individual and corporate levels. Although the plan would increase corporate taxation, it would reduce the taxes paid by individuals on their capital incomes. The DRI and Wharton analyses were confined to the effects of proposed changes in the corporate tax — and neglected the effects of shifting part of the tax burden on capital income from individuals to corporations. The Treasury plan's indexation provisions alone might reduce interest rates significantly, yet the DRI simulations assumed a first-year drop in interest rates of only 45 basis points (less than half a percentage point) and somewhat larger reductions in later years, while the original Wharton study made no allowance for the possibility of an interest rate reduction. A later study by Wharton did make such an allowance.

Although the Jorgenson approach dealt with the question of efficiency directly, some of the conference participants had doubts about the magnitudes of the results he obtained. Nevertheless, there was general agreement that the neutrality features of the Treasury plan would increase the efficiency of the use of capital.

Construction

Estimates of the long-run effects of the Treasury plan on the cost of capital for housing and commercial building were presented by David Ling of the University of Florida on the basis of work he did with Patric H. Hendershott of Ohio State University. In making their estimates, Ling and Hendershott assumed a mortgage rate of 13 percent under current tax law, an inflation rate of 6 percent, and loan-to-value ratios of 90 and 78 percent for owner-occupied and rental housing respectively. Their simulations explicitly included the major elements of the Treasury plan affecting owner-occupied housing: the reductions in personal tax rates, the elimination of the deduction for property taxes, and the repeal of preferential rates for capital gains combined with indexation of the basis for calculating the gains to be included in income. (The features not incorporated into their calculus were the limitation of the interest deduc-

tion for second homes and the increase in construction costs due to the revision of installment sales provisions.) The rental simulation model also included the effects of the revised depreciation allowances, the capitalization of construction period interest and taxes, and the adjustment of interest payments for inflation.

Ling and Hendershott were aware that adoption of the proposed indexation provisions might reduce interest rates, but they had no basis for estimating the size of that reduction. They assumed for purposes of their calculations that mortgage rates would decline from 13 to 11 percent.

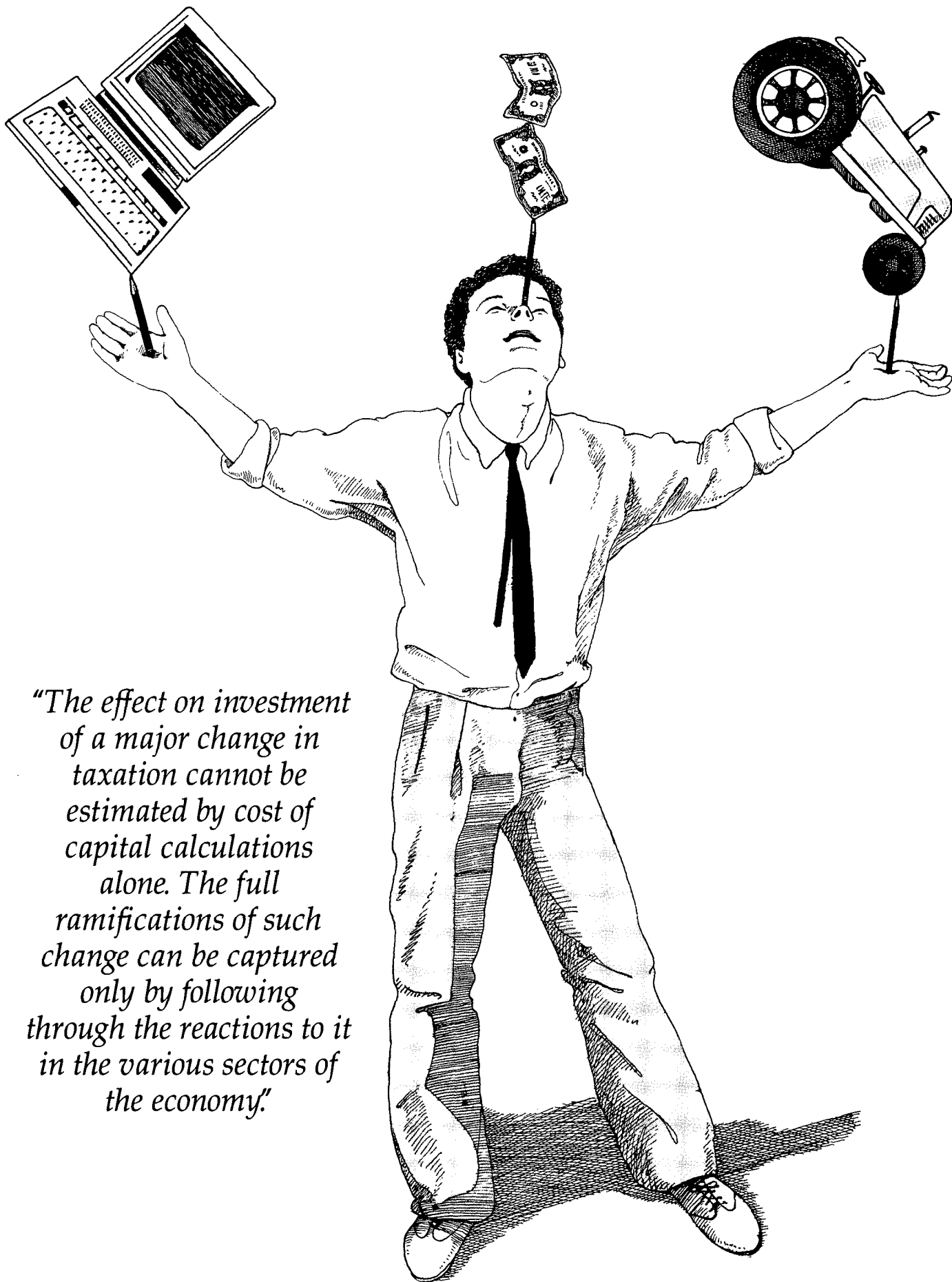
They found that with mortgage rates at 13 percent, the Treasury plan would lead to an increase in the cost of homeownership in all income classes. The increase would be small (about 2 percent) at lower income levels, but considerably larger (about 25 percent) for households with \$100,000 incomes. The rise reflects the effects of the proposed reductions in marginal tax rates (which would reduce the tax value of the interest deduction) and the elimination of the deduction for property taxes. On the other hand, if mortgage rates dropped by as much as 2 percentage points the cost of homeownership would decline in all income classes except those above \$100,000, thereby stimulating the demand for owner-occupied housing. The decline would amount to more than 10 percent in the lowest income classes and then gradually disappear as income rises.

The proposed revisions would have a more dramatic effect on the cost of rental housing. Ling and Hendershott estimate that if mortgage rates were to remain at 13 percent, this cost would rise by 44 percent. If mortgage rates were to decline to 11 percent, the cost of rental housing would increase 19 percent. These increases would be due primarily to reduced tax depreciation and indexing of the interest deduction for business enterprises.

The cost of noncorporate commercial structures would also rise, but somewhat less than the cost of rental housing would. The increase would be 36 percent if mortgage rates were at 13 percent and 13 percent if mortgage rates were at 11 percent. The smaller increase in the cost of commercial structures reflects the fact that, typically, straight-line depreciation is used for commercial structures and ACRS for residential ones, so that the change to real economic depreciation has a much larger effect on the cost of residential structures.

Ling concludes that construction of rental housing and commercial structures would decline if the Treasury plan were enacted. But owner-occupied housing would become more attractive and the ratio of owner households to renting households would rise. Clearly, the virtual elimination of tax shelter possibilities would have a major effect on the construction sector and, subsequently, on market rents.

The conference participants noted that the impact of the Treasury plan depends crucially on interest rates. If, as many believe, interest rates would decline significantly, the increase in construction costs would be moderated. Some of the participants felt that the 2 percentage-point decline assumed by Ling may be modest, so that the increase that he projects in rental costs could be overstated and the positive impact on owner occupancy understated. Moreover, his calculations assumed that the amount of debt-financing would not be altered, even though at the margin there may be some shift toward the use of equity capital as a result of interest indexation.



"The effect on investment of a major change in taxation cannot be estimated by cost of capital calculations alone. The full ramifications of such change can be captured only by following through the reactions to it in the various sectors of the economy."

Lise Gladstone

Interest Rates

Two widely different estimates of the impact of the Treasury plan on interest rates were presented to the conference. David Berson of Wharton Econometrics discussed the results of simulations he prepared with the Wharton quarterly and long-term models. John Makin of the American Enterprise Institute presented an illustrative calculation to show the possible response of interest rates to indexation.

The Wharton models predict that the Treasury proposal would lead to small increases in interest rates in both the short and long runs. In the short run, the maximum increase in the first three years would be about 30 basis points (three-tenths of one percentage point); in the long run, the rise in interest rates would be on the order of 50 or 60 basis points. The short-run increase would be attributable primarily to the increase in consumption brought about by the reduction of personal income taxes. The long-run results would reflect the decline in productivity growth resulting from the reductions in capital stock generated by the Wharton model (see the discussion above of investment effects).

In an alternative set of calculations, Berson adjusted his equations to take into account the effect of expected inflation on interest rates. He found that interest rates would decline, but that the shift would still be relatively small (about 50 basis points) after five quarters. The introduction of expected inflation into the simulation reversed the earlier results because interest rates reflect, at least to some extent, the effect of the personal income tax on the inflation component of interest income. With the reduced marginal tax rates in the Treasury plan, the tax on the inflation component would be lower and lenders would be likely to accept lower interest rates.

In still another set of calculations, Berson included the effects of the Treasury indexation proposal through its impact on the inflation premium in interest rates. This resulted in an additional decline of 70 basis points in short-term interest rates, leaving them about 120 basis points below the Wharton baseline. Long-term rates declined by roughly half this amount. Rates would be prevented from falling further primarily because of increases in real output after the initial reductions following adoption of the Treasury plan.

Makin's approach to estimating the effect of indexation on interest rates was to examine how borrowers and lenders would react to indexation. He assumed that the expected inflation rate and the after-tax real rate of return would remain fixed and then calculated what would happen if the tax burden on the inflation component of interest were to be removed. Makin calculated that with an expected inflation rate of 6 percent and an after-tax real rate of return of 3 percent, the nominal interest rate would drop from 13 percent to 11.1 percent under the Treasury's approximation to indexation. (The Treasury assumes a real rate of return of 6 percent for all assets and then removes the average percentage of the nominal rate accounted for by inflation. Thus, at a 6 percent inflation rate, half of all interest income would be removed from the tax base, and half of all interest expenses would not be deductible.) Makin observed that by selecting a high real rate, the Treasury would in practice adjust interest only partially for inflation. If a real rate closer to the historical norm were selected—say, 3 percent—the nominal interest rate would decline to 10 percent.

In general, the conference participants agreed with Makin that the Treasury's approximation to indexation would have a significant effect on interest rates. Some, in

Below is a list of those who participated in the Brookings research conference reported in the accompanying article:

Henry Aaron
Brookings Institution
Jesse Abraham
Data Resources, Inc.
J. Gregory Ballentine
Office of Management and Budget
Nariman Behraves
Wharton Econometrics
David Berson
Wharton Econometrics
Alan Blinder
Princeton University
Barry Bosworth
Brookings Institution
George Carlson
Office of Tax Analysis
Bruce Davie
House Ways and Means Committee
Peter Davis
Prudential-Bache Securities
Larry Dildine
Price Waterhouse and Company
Dan Frisch
Office of Tax Analysis
Harvey Galper
Brookings Institution
Nigel Gault
Data Resources, Inc.

Jane Gravelle
Congressional Research Service
David Hartman
Data Resources, Inc.
Walter W. Heller
University of Minnesota
Charles Hulten
Urban Institute
Dale Jorgenson
Harvard University
Thomas King
Federal Home Loan Mortgage Corporation
David Ling
University of Florida
Robert Lucke
Congressional Budget Office
Bruce MacLaury
Brookings Institution
John Makin
American Enterprise Institute
Rosemary Marcus
Congressional Research Service
Charles McLure, Jr.
Treasury Department
Joseph J. Minarik
Urban Institute
John H. Mutti
University of Wyoming

Joseph Pechman
Brookings Institution
Anthony Pellechio
Price Waterhouse and Company
George Perry
Brookings Institution
George E. Peterson
Urban Institute
Wolfhard Ramm
Board of Governors of the Federal Reserve
Robert D. Reischauer
Urban Institute
Alice Rivlin
Brookings Institution
Charles Schultze
Brookings Institution
Kenneth Simonson
Millipore Corporation
Joel Slemrod
Council of Economic Advisers
Eugene Steuerle
Office of Tax Analysis
Emil M. Sunley
Deloitte, Haskins & Sells
Kevin Villani
Federal Home Loan Mortgage Corporation
Randy Weiss
Joint Committee on Taxation

fact, felt that Makin underestimated the possible decline. The major difficulty in making precise projections on this point is that in the past, nominal interest rates have not fully reflected the effect on inflation. Consequently, if the tax penalty on interest during inflation were to be removed, the decline in nominal interest rates might not fully reflect the theoretical reduction in that penalty. Other factors, such as the exemption of the mortgage interest deduction from indexation and the continued tax exemption for retirement savings, would also limit the drop in interest rates.

Another variable that would have a major influence on interest rates is the extent to which U.S. rates are determined in international markets. Since foreigners do not pay U.S. taxes and capital flows freely across national borders in the search for the most attractive returns, nominal interest rates in the United States might decline only slightly and the after-tax cost of funds would then be higher. This would occur because the exchange rate of the dollar would fall, capital inflows into the United States would slow up, and the decline in interest rates would be arrested or even reversed. The spread between the nominal and real interest rates would decline, as in Makin's scenario, but the real rate would go up rather than remain the same.

International Capital Flows

At numerous points in the discussion, it was noted that the economic effects of the Treasury tax plan — or any other major tax revision — would depend to a considerable degree on the relationship of the U.S. economy to the world economy. If, for example, interest rates are set in world markets, nominal interest rates in the United States would remain unchanged even if taxes on business and investment income were removed. Similarly, trade and capital flows could significantly alter the results of economic analyses that implicitly assume the United States is a closed economy. To trace the effects of tax revision on international capital flows, John H. Mutti of the University of Wyoming and Harry Grubert of the Treasury Department ran simulations on their model of capital and trade flows between the United States and the rest of the world.

As reported at the conference by Mutti, the change in capital flows that the model anticipates under the Treasury tax regime are remarkably small. For example, if the proposed capital recovery provisions and corporate rate cuts were enacted without indexation, foreigners would invest more in the United States, and the U.S. capital stock would rise — but by less than 1 percent even if capital is highly mobile internationally. With the addition of indexing, interest rates might move downward for the reasons mentioned earlier, and foreigners would withdraw capital from the United States; the U.S. capital stock would decline, but again the slippage would be small — less than 0.2 percent.

An explicitly international aspect of the Treasury plan that affects these results is the proposed revision of the limitation on the foreign tax credit. Under present law, foreign taxes may be credited against U.S. taxes regardless of where the former taxes are paid. Under the Treasury plan, U.S. firms would be required to calculate tax credits on a country-by-country basis; this change would increase taxes on income from foreign sources and discourage capital outflow. However, the combination of the per-country limitation and the reduction of corporate rates would provide a

“ . . . the interest effects of domestic fiscal policies may swamp the relatively modest flows generated in a long-term model based on real variables alone.”

modest net incentive for U.S. firms to invest abroad.

Although the results of the Mutti-Grubert simulation were considered interesting by those at the conference, several participants observed that the model used does not capture all the complications that need to be included in this type of analysis. For example, U.S. firms do not pay tax on the earnings of their foreign subsidiaries until the earnings are repatriated. As seen by the subsidiaries, the U.S. corporate tax cut would increase the attractiveness of reinvesting abroad to earn future profits that would be taxed at lower rates, but it would also lower the cost of repatriating earnings to the United States instead. At the margin, therefore, the decision to repatriate would probably not be affected. On the other hand, a U.S. tax cut would increase the after-tax returns in the United States of U.S. firms and of foreigners investing in the United States, and it would encourage reinvestment of their earnings or stimulate new investment in the United States at the expense of investment abroad. It was emphasized in any event that many considerations other than taxes enter into such decisions, so that it is extremely difficult to predict how tax changes alone would affect the investment choices made by U.S. and foreign firms.

The emphasis on trade and capital flows in the Mutti-Grubert model does not take financial variables into account in determining international capital flows. In particular, outsized U.S. government deficits that generate high nominal interest rates draw large amounts of capital into the United States. Thus, the interest effects of domestic fiscal policies may swamp the relatively modest flows generated in a long-term model based on real variables alone.

Conclusions and Uncertainties

Perhaps the major conclusion that may be drawn from the conference discussion is that the Treasury tax revision plan would greatly improve the neutrality of the treatment of business investment under the income tax. ACRS, the investment tax credit, and the interest deduction reduce the effective tax rates on some assets much more than on others — indeed, in some cases they result in a negative tax, or subsidy. The narrowing of these large differences in tax rates would diminish the influence of tax considerations on business and investment decisions and thus improve the allocation of resources.

By its very nature, the Treasury plan to introduce real economic depreciation as a basis for calculating net business income would raise the cost of capital for some assets and industries and lower it for others. In general, the cost of

capital would rise for producers' durable equipment — particularly long-lived equipment, which receives very favorable treatment under present law — and highly-leveraged structures. Capital costs would go up most for transportation, communications, and public utilities and decline most for trade and services industries.

Corporation tax liabilities would increase by an average of about 25 percent over the long run (i.e., after the initial shift of future tax payments to earlier years under real economic depreciation). The basic corporate tax provisions applying to business investment — including the revised depreciation method, the repeal of the investment credit, and the new dividend deduction — would raise about as much revenue as would be lost from the cut in corporate rates. The increase in the corporate tax would come entirely from the elimination of tax preferences and tax shelters. In effect, the tax reduction of about 8 percent for individual taxpayers would be financed by eliminating the provisions that have had the most distorting effects on the economy.

The Treasury plan would raise the cost of capital for rental housing and commercial building. The cost of owner-occupied housing would also rise somewhat, because the property tax deduction would be eliminated and the rate cuts would reduce the tax value of the interest deduction on home mortgages. However, owner-occupied housing would become even more attractive relative to rental housing and other tax-sheltered building projects.

Indexation of interest receipts and expenses would raise the after-tax returns of lenders and the cost of funds for borrowers, thus increasing the supply of loans and reducing the demand for them. The two effects work in the same direction — that is, both reduce interest rates. In the present state of knowledge, it is impossible to project how much interest rates would drop, but most of the conference participants agreed that some decline would occur. Further research on this difficult issue is needed.

The effect of the proposed changes on total investment is extremely difficult to predict. Macroeconomic models, which assume that the cost of capital in the corporate sector would rise and that corporate cash flow would be reduced, suggest that total investment would decline somewhat in the early years after enactment of the tax reform package and return to — or close to — its former level in later years. At most, these projections take into account only modest effects of the indexation of interest income and expenses on interest rates. Larger declines in interest rates would increase investment. However, the short-run changes in investment that are likely to occur could be offset by an easing of monetary policy.

The improved allocation of resources over the long run would increase the efficiency of the use of capital and raise the level of output in the economy. But the magnitude of the effect is in dispute. This is another area that warrants further study.

Any tax revision as sweeping as the Treasury plan would have an enormous impact on the allocation of capital in the economy. Inevitably this means that investment would be redirected from some industries into others. But the allegation that the plan would reduce total investment is probably incorrect. The issue Congress must decide is whether the prospective efficiency improvements from greater tax neutrality outweigh the losses of those now benefiting from the distortionary features of the tax laws.

*"The issue Congress must decide
is whether the prospective
efficiency improvements from
greater tax neutrality outweigh
the losses of those now benefiting
from the distortionary features of
the tax laws."*

The New Center for Public Policy Education

Thomas Labrecque, president of the Chase Manhattan Bank, and Lloyd N. Cutler, partner in Wilmer, Cutler & Pickering and former counsel to the president. In the background: Robert W. Crandall, senior fellow in the Economic Studies program at Brookings.

IN FEBRUARY, at the winter meeting of its board of trustees, the Brookings Institution announced the opening of a new Center for Public Policy Education. In conjunction with the board meeting, the Center held a two-day series of inaugural seminars and symposia. The series included a range of programs illustrative of the types of educational activities that the Center will be offering:

- a policy development conference on the operations of Congress; among the participants were Senator Dan Quayle and Representatives Richard B. Cheney and David R. Obey.

- an exploration of the issues raised in *Assessing Tax Reform*, a forthcoming Brookings book by senior fellows Henry J. Aaron and Harvey Galper; panelists included Representative Richard A. Gephardt; Ronald A. Pearlman, assistant secretary for tax policy at the Treasury Department; and David F. Bradford, professor of economics and public affairs at Princeton University.

- a roundtable discussion of an ongoing research project, being conducted by senior fellow William B. Quandt, on options for U.S. policy in the Middle East.

- one of the Institution's regular monthly luncheons for Washington representatives of its major corporate sponsors; the speaker at this session was Alice M. Rivlin, who directs the Economic Studies program at Brookings.

- a public policy forum, for leaders of the public and private sectors, on America's policy choices in three critical areas: economic growth, international trade, and arms control.

At a special dinner for members of the board of trustees and guests of the Center, Daniel Yankelovich, the noted public opinion analyst and social commentator, spoke about the transformation of ideas into policy and about the role that public policy education can play in that process. He was introduced by Senator Daniel P. Moynihan.

The following pages include a brief essay by Bruce K. MacLaury, president of the Brookings Institution, on the new Center; a summary of Yankelovich's remarks; and photographs from the Center's inaugural programs.



A Message from the President

FOR A QUARTER of a century, the Advanced Study Program at Brookings has helped hundreds of leaders in the public and private sectors to understand the key issues on the national agenda and how those issues are resolved at the federal level. From the outset, the program was designed not only to expand executives' knowledge about public policy in general, but also and more specifically to create a greater appreciation on each side of the public/private divide of the difficult tradeoffs and pressures that decision-makers on the other side face. Small off-the-record seminars were the essential building blocks for this executive development program, a format that proved popular and effective over time.

In the past few years, Brookings has expanded its educational efforts along many dimensions. In addition to our core seminars, we now schedule day-long public policy forums on topics of current interest on a monthly basis to which the public is invited. Several of these public forums are taped for subsequent television broadcast, either in full on a cable network or in edited form for classroom and other instructional use. Selected forums are also edited for publication in a series entitled *Brookings Dialogues on Public Policy*.

Apart from "going public" with these forums, Brookings has expanded the range of policy issues that it is prepared to take on in this way. Most of the forums focus on issues that are of long-standing concern to Brookings' research staff. In some cities, they have been built around recent publications: for example, *Ballistic Missile Defense*, *Economic Choices 1984*, and *Assessing Tax Reform*. But we have also assembled outside experts in such fields as genetic engineering and environmental health to examine the policy questions in a world in which science and its consequences are racing ahead of public understanding.

The education program is also branching out geographically. For the past three years, we have conducted, in conjunction with the Japan Center for International Exchange, seminars in Tokyo for American businessmen. This exploration of the links between the public and private sectors in different cultural and political settings is a theme that strikes a responsive chord in the business community, and we are continuing to explore other opportunities. Recently, the Korean Development Institute assisted in organizing a group of Korean executives — from the public and private sectors — to participate in a program in Washington to help them better understand the policy-making process in this country. This past year we also hosted a conference in Washington at which French business and government officials — together with their American counterparts — explored what each side might learn from French experience with industrial policy.

These new dimensions in public policy education at Brookings attest to our interest in exploring diverse ways to advance public understanding of policy issues. To recognize what has already been accomplished by way of innovation and expansion, and to mark our commitment to additional investments of time and money in the policy education process, we have inaugurated the new Center for Public Policy Education. We shall of course retain what works best from the Advanced Study Program and build upon its success.

In addition to the initiatives already discussed, we plan to extend the new Center's activities in three directions. First, as new financial resources permit, we intend to offer fellowships to make it possible for leaders from the clergy, the media, labor organizations, state and local governments, and other groups who might not be able to attend because of cost to do so. Second, we plan to underwrite selected educational programs when it would be inappropriate to expect participants — government officials, diplomatic representatives, and religious leaders,

Senator Daniel P. Moynihan and Lee Fritschler, director of the Center for Public Policy Education at Brookings.



for example — to defray the costs.

Third, and potentially most important, we plan to expand what we are calling policy development conferences—sessions that bring together congressmen, their key staff members, and relevant officials from the executive branch to explore specific issues within their jurisdiction. The model for this type of activity is the Seminar on the Administration of Justice that Brookings has hosted in recent years, at which the chief justice of the United States, the attorney general, members of the Judiciary Committees, and staff members discuss, in an informal setting, key issues of judicial administration. This type of discussion can help policy-makers to anticipate future legislative problems and to resolve their differences on current issues.

Lee Fritschler, director of the Center, and his staff will be working hard to capitalize on the opportunities for public policy education and development that the expanded program offers. Together with the Brookings research staff, they will be extending and refining a range of outreach activities that can advance public understanding of the tough policy choices the nation faces.

*Bruce K. MacLaury
President of the Brookings Institution*

Public Policy Education and the Inner Dialogue

Daniel Yankelovich



DANIEL Yankelovich spoke at a special board of trustees dinner held during the Center's two-day inaugural program. As chairman of Yankelovich, Skelly & White, Inc., he is one of the leading public opinion analysts and social researchers in the country.

Yankelovich discussed the linkage between public policy education and the resolution of national issues. "The new Center," he said at the outset of his address, "has a unique opportunity, beginning afresh and yet at the same time bringing so much prestige and so many resources to bear, to innovate and to upgrade the whole process of public policy education." He proceeded to set out a framework within which to think about that process and its purposes.

His firm, Yankelovich reported, has found that issues that are resolved positively, on the basis of a national consensus, have typically passed through three stages. The first of these is what he called consciousness-raising — the building of public awareness that a problem exists and needs to be addressed. The second, which he labeled the inner dialogue, is a phase during which people consider — in their own ruminations and in conversations with others — the pros and cons of alternative courses of action. "This working through process," Yankelovich said, "takes a great deal of time. It can go on for months and, on certain issues, for years." But, according to Yankelovich, it is crucial. The third stage is one of political brokering and compromise, what Yankelovich termed the Washington phase.

Yankelovich urged that public policy educators devote less attention to consciousness-raising — "we have more than enough of that" — and more attention to helping the public into and through the second phase described above. What the public needs, he said, is "the raw material . . . to carry out this inner dialogue with themselves — the choices, and the pros and cons of the choices." Policy-makers, he observed, have a tendency to go through the inner dialogue process on an issue, reach a conclusion about what should be done, and then get impatient when the public, which has not yet engaged the issue in its own inner dialogue, does not immediately recognize the wisdom of the policy-makers' judgments.

Nuclear Stability: Vulnerability . . .

“THE NUCLEAR stalemate has served us well despite its inherent dangers,” according to a new Brookings study. The key to continued nuclear stability, writes author Michael Nacht, is further reduction in the vulnerability of weapon systems. In *The Age of Vulnerability: Threats to the Nuclear Stalemate*, Nacht analyzes several mechanisms for minimizing this vulnerability: deceptive and mobile basing, defenses, and arms control.

He suggests that the best way to decrease the vulnerability of intercontinental ballistic missiles would be to combine base mobility with concealment; it is this combination, he notes, that makes missile-carrying submarines invulnerable. He does not advocate moving all U.S. missiles to the sea, however, because this would make the missiles susceptible to antisubmarine warfare and would concentrate U.S. targets for Soviet countermeasures. Instead, he urges that missiles be deployed “on short takeoff and landing (STOL) amphibious aircraft, which can move continuously and land randomly on the high seas, in coastal waters, in inland waterways, or on land.”

This basing strategy, says Nacht, would make Soviet targeting extraordinarily difficult. “The amphibious alternative, and no other,” he writes, “would enhance ballistic missile survivability, be easily embraced within the existing arms control regime [because the number of deployed aircraft can be verified], and meet the powerful American domestic political constraints that have plagued this issue for a decade.”

Nacht acknowledges that the most formidable obstacle to this approach is organizational: “A suitable air force-navy mixed-service arrangement must be found for program implementation to succeed,” he writes. But this is one case, he asserts, “in which the attractiveness of the concept should drive organizational considerations rather than permit entrenched vested interests to produce undesirable and dangerous strategic policies.”

If arms control is to play a constructive role in national security policy, Nacht writes, “it must be seen for what it is intended to be: threat control.” According to the author, “Numbers of weapon systems or warheads tell us little about stability. . . . The aim of arms control should be to reduce vulnerabilities, not to reduce numbers per se.” It is far more important, he indicates, “to control a single effective counterforce system than to reach agreed numerical ceilings on a wide range of forces while permitting major threats to continue unabated.”

Nacht adds that threat control need not be symmetrical: “There is nothing in principle to block a one-for-one asymmetrical agreement as long as each side believes that the net vulnerability of its forces has been reduced.”

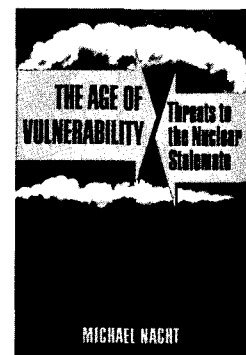
In his study, Nacht also evaluates seven threats to the nuclear stalemate:

- the pervasive insecurity felt by the Soviet people and top Soviet leaders;
- the dual personality of the U.S.—seeking both strength and peace—combined with the resurgence of American anticommunism;
- the deployment of high-accuracy weapons, which increase the vulnerability to attack of all stationary and many mobile targets and thereby heighten the sense of insecurity in the U.S. and the Soviet Union;
- the adoption of doctrines for fighting nuclear wars, although what is said during peacetime is not necessarily an accurate predictor of what may be done during war;
- the failure of arms control to contain or control the principal threats to each side’s forces;

The Age of Vulnerability: Threats to the Nuclear Stalemate

by Michael Nacht

\$9.95 paper; \$26.95 cloth.



- the frictions between the U.S. and its European and Japanese allies, who depend on U.S. guarantees for their own security;
- the prospects of nuclear proliferation in other countries, stimulated by the intensity of the U.S.-Soviet arms competition.

Nacht observes that despite these threats to nuclear stability, "fear of use of nuclear weapons seems to dominate the views of political leaders in both Washington and Moscow." He concludes that "the nuclear stalemate remains in place" and that "it will take truly revolutionary technological innovation or a massive exercise in human stupidity before this stalemate is seriously threatened."

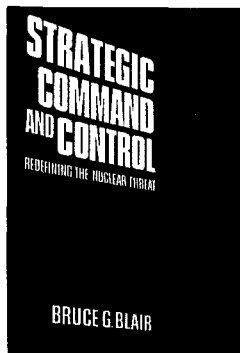
Nacht teaches national security policy and public management at the University of Maryland's School of Public Affairs.

... and Control

Strategic Command and Control: Redefining the Nuclear Threat

by Bruce G. Blair

\$12.95 paper; \$32.95 cloth.



THE DEFICIENCIES of the U.S. command, control, communication, and intelligence system (C³I) weaken nuclear deterrence, according to Bruce G. Blair, the author of *Strategic Command and Control: Redefining the Nuclear Threat*. He finds also that if the Soviets launch a surprise nuclear attack, the ability of the United States to retaliate is less certain than is commonly believed and officially asserted.

Blair argues that the vulnerability of the U.S. control system casts doubt on America's traditional deterrence strategy, which is based on the threat of swift, comprehensive retribution in the event of nuclear attack. This shortcoming also undermines the newer strategy of flexible response that envisions a protracted war. Moreover, he contends, the severe time pressures and information constraints that the current control system would impose on national leaders also heighten the risk of inadvertent war due to false alarms, misperceptions, or miscalculations.

These threats to national security stem largely from the fact that the nation's nuclear control system has historically been neglected while the arsenal it supports has received lavish attention and resources, Blair writes. This imbalance produced a powerful survivable arsenal, but placed it under weak, vulnerable control.

Blair bases his arguments on an assessment of strategic command performance over the last 25 years. He traces the evolution of the physical and procedural arrangements that were created to direct U.S. strategic forces in time of war. After analyzing their strengths and weaknesses, he concludes that these arrangements, not the arsenal itself, are the key determinants of real strategic capability. He contends that the standard practice of gauging this capability on the basis of arsenal comparisons and calculations of force vulnerability leads to wrong or misleading conclusions.

"Although standard assessment produces the comforting conviction that the United States could absorb the Soviets' maximum nuclear attack and inflict socially mortal damage to the Soviet Union in retaliation, the Soviet Union has actually posed a severe threat to U.S. retaliatory capabilities since the mid-1960s," he writes.

He assesses command performance in the mid-1960s, early 1970s, and mid-1980s. Throughout the years, the chronic imbalance between the development of weapons and the strengthening of the command system jeopardized national security and created the most plausible route to Soviet victory in nuclear war. As of the mid-1980s, he says, "a variety of command deficiencies — the extreme vulnerability of the ground segment of C³I, the considerable prelaunch and postlaunch vulnerability of the airborne segment, deficient airborne communications, and the questionable performance of emergency rocket and satel-

lite communications systems—undermine the ability of the United States to keep nuclear operations and national security objectives aligned during war.”

An examination of flexible response in the 1980s leads Blair to conclude that the present rudimentary control system is unable to support this sophisticated doctrine. The United States, he cautions, has adopted a doctrine that bears little relation to its actual capabilities and hence fosters an illusion that nuclear war would be subject to restraints.

Blair notes that ongoing efforts to strengthen the nuclear control system are being promoted as the centerpiece of President Reagan's plan for strategic modernization, but he says that the appearance of a clear consensus on this priority is misleading. “The Reagan administration has advanced a cogent argument for command modernization,” he writes, “but has not firmly grasped the complexity of the challenge it has set for itself.” If history is any guide, he adds, “C³I modernization is destined to fare poorly in the competition for scarce resources. Fundamental changes in the perception of the strategic problem and in the legal and institutional mechanisms that govern programs and budgets are probably necessary to bring about the kind of nuclear control system that the United States deserves and needs.”

Blair advocates a near-term goal of assured retaliation. The achievement of the goal would require redoubled efforts to create a control system that will not collapse under the weight of a Soviet first strike, he says. In order to ensure the capability to inflict severe punitive damage in retaliation, budgetary support for the C³I programs in the five-year defense plan must be sustained and new programs such as undersea command posts should be initiated.

The primary long-term objective in nuclear modernization should be to give the president the option of holding in reserve all or part of the U.S. arsenal in the event of Soviet attack, with the assurance that he could later direct those forces to coherent security purposes. Strategic organizations expect to receive retaliatory authorization within minutes after initial detection of missile launches. That expectation is so deeply ingrained that, under current plans, the post-detection nuclear decision process would consist of only a brief emergency telecommunications conference, the purpose of which would be to obtain a decision from the national command authority before incoming weapons arrive. Given the vulnerability of the current C³I system, officials have at most several hours in which to reach a decision.

“A long-term goal of nuclear modernization,” Blair writes, “should be to adopt a policy that allows for no immediate second use. The basic justification for this policy is that nuclear decisionmaking should not be reduced to reflexes and brief drills, but should instead be regarded as a careful deliberative exercise of national leadership that could take days or longer.”

Under a doctrine of no immediate second use, survival actions would take strong precedence over counterattack coordination during and after a Soviet first strike. Authority to conduct offensive operations would be withheld for at least 24 hours, and military units would be programmed to operate accordingly.

“More enduring or reconstructible command, control, communications, and intelligence systems must be provided if effective delayed retaliation is to succeed,” he writes. “The existing intelligence system cannot be relied on to assess damage caused by a Soviet attack. The United States needs to develop intelligence systems that can generate reliable, accurate, and current reports as the damage occurs.” He also urges the development of command centers that can withstand a massive attack and can continue to function long afterwards. Current arrangements, he says, place too much reliance on airborne command posts.

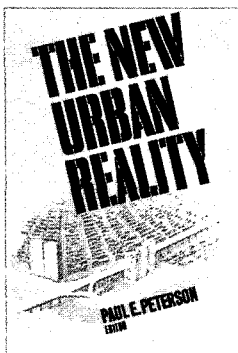
The doctrine of no immediate second use would promote stability in times of crisis, Blair says. “Insofar as it fosters deployment of a more survivable C³I network, it might reduce incentives for preemptive attack and relieve pressures for early employment of U.S. forces.” This doctrine aims to restore confidence in U.S. ability to exercise a minimum degree of positive control under a wide range of adverse conditions. It would also establish that the U.S. threat of retaliation could not be removed by a sudden attack on its command system and thus alter Soviet calculations of the military advantage of first strike, reducing their incentive to initiate attack in a crisis, he writes.

Blair, who was a research associate in the Brookings Foreign Policy Studies program when he wrote this book, is now at the Department of Defense.

Renewing Urban Policies

The New Urban Reality

Edited by Paul E. Peterson
\$11.95 paper; \$31.95 cloth.



TWO TYPES of urban change have left America's older industrial cities in severe decline: technological innovations in transportation, communication, and manufacturing, which have made cities' infrastructures and land-use patterns obsolete; and accelerating racial change, which has made inner cities the primary homes for minority group members, particularly those with low incomes and low job skills.

In *The New Urban Reality*, urban experts examine these developments and consider what public policies are needed to address the difficulties generated by them. The volume was edited by Paul E. Peterson, director of the Brookings Governmental Studies program.

In his introduction to the book, Peterson argues that the programs designed two to three decades ago to save the industrial cities by redeveloping central business districts are no longer practical. "Economic and social changes have moved so far that reversing their direction no longer seems feasible or even desirable," he writes.

The best urban policy, he suggests, would be one aimed at dispersing racial concentrations by increasing the choices available to racial minorities. He recommends the creation of a centralized national welfare system. He proposes a uniform set of welfare and medical policies, which would eliminate the incentives that welfare recipients, and others in need of medical and social services, now have to locate or remain in urban areas where benefit levels are higher.

A consolidated system of administration would also "allow for greater centralization of information and improved ability to minimize fraudulent activity," Peterson writes. He adds that central cities would be relieved of their responsibilities for the plight of the poor and could then concentrate on matters of urban development that are more within their scope of competence.

Peterson notes that each city has to decide for itself how best to attract residents and firms: "Since the correct strategy varies from place to place, it is best developed at the local level where people have intimate knowledge of the factors most likely to affect success."

In the concluding chapter of the book, Anthony Downs, a senior fellow in the Brookings Economic Studies program, says that he sees little hope that racial integration will in and of itself solve urban problems. But he does find cause for optimism in the internal resources of America's minority communities.

"The most obvious strategy for a sizable minority in any big city is to gain political control of the city's government," he writes. A mayor can provide city government jobs to minority group members, he argues, and minority control of city hall increases the bargaining power of minorities in relation to major property owners and strengthens their political power vis-à-vis members of Congress and state legislators.

The best natural political allies for minority groups, Downs says, are those who stand to lose the most if the minority community cannot produce competent workers: businesses locked into the city itself, such as downtown property owners, banks, and newspapers.

He suggests several other tactics for minority community groups:

- constantly emphasizing that increased spending on the education of minority-group children is an investment in the city's future, not just an aid to the poor;
- focusing public attention on the poor quality of minority schools;
- shaking up the public school bureaucracy by seeking the creation of a voucher

system to support competition among schools.

The volume also contains essays by:

— John D. Kasarda of the University of North Carolina on the growing mismatch between inner-city jobs and residents. He finds that entry-level jobs are opening in areas outside the central cities — jobs that the poor cannot seek, because of racial discrimination, inadequate knowledge and resources, or subsidized ties to the central city. He proposes policies that would partially underwrite distant job searches and relocation expenses.

— Brian J.L. Berry of Carnegie-Mellon University on the economics of inner-city gentrification. The gentrification movement has had only a marginal effect on the renewal of inner-city neighborhoods, he says.

— Elijah Anderson of the University of Pennsylvania on race relations in a gentrifying inner-city neighborhood.

— William Julius Wilson of the University of Chicago on the social and economic problems of inner-city blacks. He says that their welfare has deteriorated seriously since the 1960s and that failure to address the issues of black unemployment will only aggravate this situation.

— Gary Orfield of the University of Chicago on the need for bold efforts to reverse the ongoing patterns of racial segregation in urban areas.

— Kenneth A. Small of the University of California at Irvine on the impact of transportation policy. He finds that the relationship between transportation planning and central-city decline is less close than commonly believed. He suggests that the only transportation reform that could help the central cities is one that improves mobility within the city — upgrading intracity transit and improving traffic flow.

— Herbert Jacob of the University of Wisconsin on urban crime. He finds that spending increases for programs to fight crime have not been effective, and he recommends that more emphasis be placed on public education efforts.

— Terry Nichols Clark of the University of Chicago on the effects of political factors on the fiscal condition of cities. He says fiscal strain is a function not only of limited economic resources, but also of the preferences of citizens and political leaders.

The papers that comprise this book were originally presented at a conference at the University of Chicago.

Internationalized Assembly and International Trade

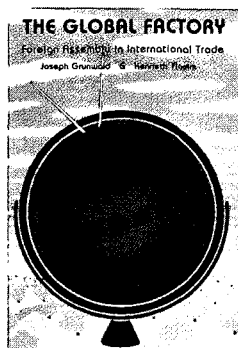
CLOSE TO 15 percent of U.S. manufactured imports consist of U.S. components that have been assembled abroad. According to a new Brookings study, foreign assembly has consistently grown two to three times as fast as all U.S. trade over the last two decades. The emergence of export-led industrialization programs in many developing countries has threatened some labor-intensive industries in developed countries. This has strained economic relations between the developed and developing countries, according to the authors of *The Global Factory: Foreign Assembly in International Trade*.

Kenneth Flamm, a research associate in the Brookings Foreign Policy studies program, and Joseph Grunwald, formerly a senior fellow in the same program and now the president of the Institute of the Americas at the University of California — San Diego, examine assembly trade between developed and developing countries, focusing on the transfer of labor-intensive assembly operations abroad. Assembly trade is closely bound up with technology-intensive industry in the U.S., they write. Semiconductors account for over 40 percent of the value of U.S. components reimported into the U.S. after overseas assembly, with much of the remainder incorporated into other electronic goods.

The Global Factory: Foreign Assembly in International Trade

by Joseph Grunwald and
Kenneth Flamm

\$10.95 paper; \$29.95 cloth



Grunwald and Flamm consider in detail the worldwide internationalization of production in the "high tech" semiconductor industry. It was the first to institute offshore assembly on a large scale in the mid-1960s, and it remains the single most important U.S. industry dominated by foreign sourcing arrangements. More than 80 percent of U.S. semiconductors are probably assembled abroad. The authors chart the development of the semiconductor industries of Western Europe and Japan, showing the strengths and weaknesses of policy alternatives pursued by other countries in this rapidly growing, highly competitive industry.

They then analyze the activities of the U.S. and three of its near neighbors: Mexico, Haiti, and Colombia. Mexico, which shares a 2,000-mile border with the U.S., is the most important U.S. partner in assembly activities abroad, followed by the newly-industrializing countries of Southeast Asia. Haiti, one of the poorest countries in the world, has received a strong economic stimulus from assembly. The explosive growth of Colombian assembly for the U.S. market came about as that country grew to be the fifth largest industrial producer in Latin America.

Close to one-quarter of U.S. manufacturing imports from less developed countries (LDCs) are U.S. goods that have been assembled in those countries—a sharp contrast to the situation in Europe, where the number of such imports is negligible, and in Japan, where, while increasing, the number remains small.

Grunwald and Flamm show that "because huge international disparities in wages have persisted while costs of transport and communications have dropped, underdeveloped regions have become increasingly competitive in the production of labor-intensive goods." In these labor-intensive industries, the authors find that the shift to offshore assembly accelerates particularly rapidly during economic slumps. Most trade takes place within the U.S. multinational corporations, not as imports from foreign firms.

The international reorganization of production is an essentially reactive strategy of businesses in industrial countries that face competition from low-cost imports, they write. "In an attempt to defend domestic markets against international competition, rather than as an aggressive move against competitors at home, producers have transferred abroad production processes in which they have lost their competitive advantage."

They argue that the growth of foreign assembly is part of a continued restructuring of U.S. industry, and that "as long as the technological innovation and knowledge of the United States is substantially superior to that found in developing countries, the production design and high tech processes of an industry will remain in the United States."

The negative impact of offshore assembly for the U.S. economy has been the loss of jobs for less-skilled assembly workers. The most important impact for developing countries has been the foreign exchange earned. In addition, there has been a significant stimulus to employment in some of those nations.

Grunwald and Flamm conclude that offshore assembly is going to continue to be important for U.S. industries, and that it will continue to be a source of downward pressure on wages for less-skilled workers in the U.S. The alternative to offshore assembly is automation, and although there is a trend toward increasing automation, which may bring assembly operations back to the U.S., two factors offset it. First, the overall growth rate in technology-intensive industry has been so high that the absolute amount of offshore assembly has continued to grow; and second, rapidly changing high tech products will continue to require the greater flexibility of labor-intensive assembly.

The authors suggest legislative reforms that can make foreign assembly more useful. They also suggest that developing countries could increase the benefits from these operations by taking steps to encourage linkages to their domestic economies. They caution that the future prospects of the less-skilled assembly work force in the U.S. are rather poor, and they urge that more attention be paid to improving the skills of U.S. labor.

They write: "Given the social costs of an unplanned transition and the amount of skilled labor required by an increasingly important high technology, large-scale investment in upgrading the U.S. work force should be the preferred choice."

America and the Persian Gulf

COMING AT the end of a decade during which oil prices rose sharply, Iran's revolution and the Soviet invasion of Afghanistan in 1979 raised fears in the United States that vital interests in the Persian Gulf region were suddenly in danger. Yet U.S. military planners and diplomats who urgently sought to develop a means of projecting U.S. forces into the region were frustrated by Gulf rulers who seemed unconcerned by the Soviet threat and who were reluctant to grant U.S. forces unfettered access to bases in their countries.

In *Arms and Oil: U.S. Military Strategy and the Persian Gulf*, Thomas L. McNaugher argues that "the frustrations borne at that time may not have been in vain." A research associate in the Brookings Foreign Policy Studies program, he contends that Gulf rulers may have "helped prevent the United States from rushing too quickly into a complicated and politically delicate situation where its presence could make things worse."

With the current oil glut the crisis atmosphere of 1980 has subsided, giving the U.S. time to reconsider its approach to Gulf security. McNaugher recommends a selective, low-key approach designed to strike a workable balance between the risks of overinvolvement and the risks of neglect. The U.S. must be prepared to deter Soviet military action around the Gulf, he writes, principally by bolstering the agility rather than the size of its forces. At the same time, it should cultivate the traditional security mechanisms of the oil-rich states of the Arabian Peninsula and cooperate with countries like Jordan, Pakistan, and Great Britain that historically have been involved in Gulf security.

Although the possibility of Soviet military action against Iran or Pakistan cannot be ignored, McNaugher notes, it is not as likely as many thought in 1979 when the Soviets invaded Afghanistan. According to the author, the Soviets are not as interested in controlling the Gulf's oil as they are in protecting the security of their own border. He adds, however, that concern in Moscow about turbulence in the area—or about a possible U.S. buildup there—could lead to military action that would increase Soviet leverage over the flow and price of oil. Although most U.S. planning has focused on options in the event of a Soviet invasion to seize Iran's oil wells, McNaugher argues that even a limited incursion into northern Iran would intimidate local states like Iraq and Saudi Arabia and might give Moscow more say in decisions about oil production.

He argues that the United States cannot hope to defend all of Iran from such an invasion. Doing so would take more divisions than are currently active, and placing forces near the region would upset local friends and probably draw a larger Soviet military contingent into the region. McNaugher suggests that unless and until the Soviets show more interest in military action than they have thus far, the U.S. should pursue a strategy of conventional deterrence aimed at confronting the Soviets near their border with Iran and raising the costs and risks to them of conventional military attack.

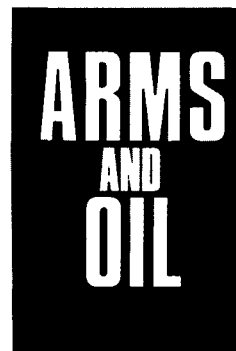
The author recommends that to achieve the force agility that such a strategy requires, the United States position the equipment for an additional division aboard ships near the Gulf and purchase eight more fast sealift vessels. He also proposes that U.S. military planners consider "surging" forces from other areas for short-term use in the Gulf. The total life-cycle cost of these measures would be about \$10 billion. "That figure is not high considering that the U.S. would be protecting interests likely to be vital for years to come."

Because a campaign along the lines described would require elaborate staging, the United States must seek access to local bases. McNaugher notes that Israel, which U.S. policy-makers often view as the one reliable regional ally in the area, could play a limited role in such an operation. He cautions, however, that "the United States should not rely solely on Israel, nor should U.S.-Israeli ties be al-

Arms and Oil: U.S. Military Strategy and the Persian Gulf

by Thomas L. McNaugher

\$9.95 paper; \$26.95 cloth.



lowed to undermine constructive relations with the Gulf states themselves." Bases in these states, as well as in Turkey, are likely to be vital to deterring Soviet action around the Gulf. Military planners must learn to live with the uncertainties inherent in a situation in which the projection of forces depends largely on diplomatic success in gaining access.

McNaugher examines the U.S. role in supporting friendly regimes in the six peninsular states—Saudi Arabia, Kuwait, Bahrain, Qatar, Oman, and the United Arab Emirates. He indicates that for the rulers of these states, the most pressing security concern is internal violence brought on by rapid economic development and the forces of religious fundamentalism and Arab nationalism.

Local rulers use "diplomacy, familial and political intrigue, and traditional methods of political control far more than force to control internal violence," McNaugher says. In 1981 the six peninsular oil states formed the Gulf Cooperation Council (GCC) for security purposes. Although there has been much talk about the military potential of this organization, McNaugher notes that the GCC's military forces "are disorganized for a purpose and will continue to be disorganized as long as these forces seem to pose a threat to GCC rulers." Thus, the rulers are likely to continue to rely primarily on traditional methods to enforce internal security.

When violence does erupt, these rulers usually call for outside help from states like Jordan and Pakistan. This tactic has been successful, McNaugher writes, principally because "in crises enemies' enemies have become friends, tacitly or explicitly, and because geographic and political circumstances make it difficult to attack the peninsula." Still, he adds, "GCC rulers buffer themselves from external helpers for the same reason that they emasculate their own military forces; doing otherwise could be dangerous."

McNaugher recommends a U.S. policy of "cooperative, understated support of the GCC's traditional security mechanisms." He suggests that the United States focus its own military planning on deterring or meeting attempts by outside powers to invade the peninsula. This approach would keep the United States from getting embroiled in the GCC's internal affairs, an area "about which the United States knows little compared with other countries whose involvement is already well established."

The use of force to seize oil wells, an option much discussed after the 1973 oil embargo, cannot be completely discounted, McNaugher writes. But he notes that the costs of such an operation would be higher than recognized by many who proposed the idea. He argues that while the U.S. must plan to use force offensively to seize oil wells, the country should plan to move last rather than first in doing so, sharing the security burden with other countries likely to be hard hit by stiff increases in oil prices. "Unilateral U.S. military action," he says, "is not the most prudent course nor particularly necessary, except when it is clear that only U.S. forces could handle the threat."

The low-key diplomatic approach counseled by McNaugher "allows military planners to focus on a few key scenarios for which the forces amassed under the U.S. Central Command (CENTCOM) seem to be well suited. More important, concentrating U.S. military efforts principally on the most extreme security threats brightens the prospects for gaining public support for military operations."

McNaugher urges that the U.S. give priority to the refinement of its relationships with the GCC states and those regional and Western powers intimately involved in peninsular security. According to the author, this would not require formal agreements so much as it would careful consultations. He adds that "cooperation must be improved on margins where the payoffs are likely to be highest."

McNaugher notes that U.S. military planners may be uncomfortable with a strategy that involves informal cooperation and leaves major security missions to others. "Worst case planning," which is the typical approach to security problems, would lead them to want to take on more of the local security burden. McNaugher argues, however, that they "must balance their sense of the region's importance and vulnerability with a sense of the dangers in seeking a U.S. solution to the region's security problems." In this part of the world, he concludes, "it is wiser to adjust plans to changes rather than to plan to cover all possibilities at the risk of producing the more alarming among them."

Immigration Problems

THE FEDERAL government's failure to devote enough attention and resources to the enforcement of immigration policy has contributed to the serious immigration problems now facing the United States, according to a new Brookings book, *Immigration — The Beleaguered Bureaucracy*. The author Milton D. Morris, claims that the high incidence of illegal immigration is as much a result of this failure as it is of external forces.

Morris argues that the inadequacies of the immigration bureaucracy are, first and foremost, products of the society's longstanding ambivalence about immigration and the political stalemate this ambivalence has produced. Because there has not been a strong or persistent constituency pressing for improved performance of the bureaucracy, Congress has been inattentive to the need for both structural and procedural reforms.

Morris outlines the developments here and abroad that have combined to make enforcement of immigration policy both complex and demanding. One is the increase in routine international travel, with the United States being one of the most popular destinations. Another is the political and economic turmoil in other countries that have increased emigration at the same time that many traditional host countries have adopted more restrictive immigration policies. Still another factor is increased sensitivity in the United States toward the civil rights of individuals regardless of their citizenship status.

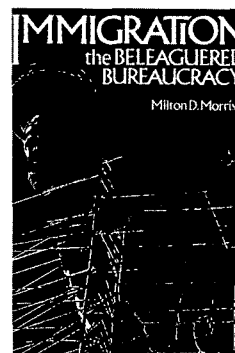
Morris suggests that not only reforms in immigration policy, but also steps to strengthen the immigration bureaucracy are urgently needed. To the latter end, Morris urges: undertaking a major study of the structure of the immigration bureaucracy with a view toward reducing the fragmentation that now exists and creating a stronger enforcement agency; greatly increasing the money available to the Immigration and Naturalization Service (INS) to modernize its record-keeping and improve its performance of routine service functions; expanding the Border Patrol so that it can do a more effective job of reducing unauthorized border crossings; and overhauling the procedures used by the INS to detect and apprehend illegal immigrants, so that these procedures conform better to current standards of individual rights. Morris argues that such improvements in the immigration bureaucracy could substantially reduce illegal immigration.

Morris, formerly a senior fellow in the Brookings Governmental Studies program, is now the director of research at the Joint Center for Political Studies.

Immigration — The Beleaguered Bureaucracy

by Milton D. Morris

\$8.95 paper; \$22.95 cloth.





1775 MASSACHUSETTS AVENUE N.W. WASHINGTON D.C. 20036

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED